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The Evolving Governmental Retirement Plan Landscape After the Pension Protection Act

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INTRODUCTION

For decades, governmental retirement plans have been exempt from many of the Code[1] rules governing tax-advantaged retirement plans. Sponsors of these plans have had a number of tax-advantaged benefit structures available to meet the retirement needs of their employees, including tax-qualified plans under Code section 401(a), tax-deferred annuities under Code section 403(b), eligible deferred compensation plans under Code section 457(b), and deemed IRAs. This unique treatment continued in 2006 with the enactment of the Pension Protection Act.[2] This article focuses on significant changes to the Code made by the PPA that affect governmental plans and the challenges these changes create for governmental plans.

I. Special PPA Rules Applicable Only to Governmental Plans

There are six key provisions in the PPA that are expressly designed for governmental plans that have created new opportunities for governmental plan sponsors to provide additional flexibility in their plan designs.[3]

A. Code Section 402(l) – Distribution to Pay Premiums for Health and Long Term Care Insurance For Public Safety Officers

With rising retiree health care costs, many governmental employers have been looking for ways to utilize retirement plan assets on a tax-advantaged basis. While Code sections 401(h) and 420 allow limited use of retirement plan assets for health care costs, some other approaches have been rejected by the IRS.[4] The PPA added new Code section 402(l),[5] effective January 1, 2007, that provides a welcomed means to use pension benefits to pay for health care costs on a tax-free basis. Specifically, Code section 402(l) permits, but does not require, governmental employers to allow an "eligible retired public safety officer" to elect a tax-free distribution from an "eligible retirement plan" of up to $3,000 annually for "qualified health insurance premiums." Recent IRS guidance[6] provided some helpful insights on the implementation of Code section 402(l). The details of the Code section 402(l) rules are as follows:

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[1] Internal Revenue Code of 1986, as amended.
[2] Pension Protection Act of 2006 (PPA), P.L. 109-280, Aug. 17, 2006.
[3] Other provisions of the PPA, such as Code § 457(e)(11)(D), also relate to governmental plans.
[4] *E.g.*, Rev. Rul. 2005-55, 2005-2 C.B. 284.
[5] PPA § 845.
[6] Notice 2007-7, I.R.B. 2005-7, Q&As 20-27 (Jan. 10, 2007).

- *Qualified Health Insurance Premiums*. Tax-free distributions must be made for "qualified health insurance premiums." Qualified health insurance premiums mean premiums for coverage for an "eligible retired public safety officer," his spouse, and dependents, by an accident or health insurance plan or qualified long-term care insurance contract.[7] The recent IRS guidance clarified that accident or health plans can not be self-insured; the tax relief only applies to insurance issued by an insurance company regulated by a State (including a managed care organization that is treated as issuing insurance).[8] However, it appears that the Service has since changed its position (in light of pending legislative action) and will interpret the provision to extend to an "accident or health plan" as such term is defined under Code section 105 (and the regulations thereto), which expressly includes self-funded plans.[9]

- *Eligible Public Safety Officer*. Only "eligible retired public safety officers" are eligible under the Code section 402(l) rules. An "eligible retired public safety officer" generally means an individual who: (1) separates from service as a "public safety officer,"[10] (2) separates from employment due to a disability or reaching normal retirement age, as such terms are defined under the plan, and (3) elects to make a distribution directly from an "eligible retirement plan"

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[7] Code § 402(l)(4)(D). The term "qualified long-term care insurance contract" is defined in Code section 7702B(b).

[8] Notice 2007-7, I.R.B. 2005-7, Q&A 23.

[9] Letter from K. Fromer to Hon. J. McCrery, May 15, 2007.

[10] A "public safety officer" is defined in Code § 402(l)(4)(C) through a cross-reference to section 1204(9)(A) of the Omnibus Crime Control and Safe Streets Act of 1968 as:

(A) an individual serving a public agency in an official capacity, with or without compensation, as a law enforcement officer, as a firefighter, as a chaplain, or as a member of a rescue squad or ambulance crew;

(B) an employee of the Federal Emergency Management Agency who is performing official duties of the Agency in an area, if those official duties –

(i) are related to a major disaster or emergency that has been, or is later, declared to exist with respect to the area under the Robert T. Stafford Disaster Relief and Emergency Assistance Act; and

(ii) are determined by the Director [Administrator] of the Federal Emergency Management Agency to be hazardous duties; or

(C) an employee of a State, local, or tribal emergency management or civil defense agency who is performing official duties in cooperation with the Federal Emergency Management Agency in an area, if those official duties –

(i) are related to a major disaster or emergency that has been, or is later, declared to exist with respect to the area under the Robert T. Stafford Disaster Relief and Emergency Assistance Act; and

(ii) are determined by the head of the agency to be hazardous duties.

(maintained by the governmental employer) for qualified health insurance premiums. The provision extends to benefits attributable to service other than as a public safety officer, as long as the employee separates from service as a public safety officer with the employer maintaining the eligible governmental plan.[11]

- *Eligible Retirement Plans*: Code section 402(l) applies to governmental Code section 401(a), Code section 403(a), Code section 403(b) and Code section 457(b) plans.[12]

- *$3,000 Limit*: The $3,000 annual limit is an aggregate limit that applies to the total of all distributions from all plans eligible for the Code section 402(l) rule. Further, the recent IRS guidance clarifies that the amounts excluded from income under this provision are not taken into account in determining the itemized deduction for medical expenses on Schedule A of Form 1040.[13]

- *Death of a Participant*: Unlike other IRS guidance in the welfare arena,[14] after the employee dies, the provision does not apply to distributions to his or her surviving spouse or dependents.

Although the recent IRS guidance provided helpful clarifications on the operation of Code section 402(l), a number of issues continue to be raised by governmental employers, including the following questions:

- *Does Code section 402(l) cover premiums paid to non-employer sponsored health plans?* The term "accident or health insurance plan" is not defined in the new provision, but the conference report indicates that the premiums do not have to be for a plan sponsored by the employer. The term "accident or health insurance" is used under Code section 104(a)(3) (and related Code sections 105 and 106 for employer-provided plans) and has historically included medical, dental, vision, and more recently cancer insurance (as long as there is no savings or investment feature), and other amounts for personal injury or sickness. Moreover, under Code section 105(e), the statute states that, for purposes of Code sections 104 and 105, amounts received under an accident or health plan for employees shall be treated as amounts received through accident or health insurance. Therefore, it is reasonable to interpret this provision to cover both individual policies and employer-provided plans (including a plan maintained by the spouse's employer). However, governmental plans should be aware that the IRS has initially applied the term "insurance" narrowly in disallowing payments to self-insured arrangements under Code section 402(l), and the pending IRS guidance may limit this provision to accident or health plans under Code section 105, which only covers employer sponsored plans.[15]

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[11] Notice 2007-7, I.R.B. 2005-7, Q&A 24.
[12] Code § 402(l)(4)(A).
[13] *E.g.*, Notice 2007-7, I.R.B. 2005-7, Q&A 27.
[14] Notice 2002-45, 2002-2 C.B. 93, Jun. 26, 2002 (guidance on health reimbursement arrangements).
[15] Notice 2007-7, I.R.B. 2005-7, Q&A 23.

- *What happens if multiple "normal retirement ages" are set forth in the plan?* It is unclear what approach should be taken if a single plan contains multiple "normal retirement age" definitions (*e.g.*, for different groups/benefit levels). The IRS position may, however, require that a single "normal retirement age" be used for this purpose. This position could be problematic if the latest age in the plan must control. However, no position was formally taken in the recent IRS guidance.

- *Would a separate policy for the spouse or dependent qualify for the exclusion?* The statute says coverage for officer, his spouse, "and" dependents, by an accident or health insurance plan or long-term care contract.[16] The PPA Committee Report and the recent IRS guidance also use the word "and" rather than "or." The recent IRS guidance expressly says the option is not available if an employee dies, but it is unclear if the exclusion is available while an employee is alive.[17]

- *Would a check made payable to the health care provider, but delivered to the participant, meet this exclusion?* Although this approach is expressly permitted for direct rollovers under the IRS' rollover guidance,[18] which is an analogous context, the IRS has not directly addressed this issue at this time.

- *Does the $3,000 exclusion count for required minimum distribution proposes?* Although the recent IRS guidance expressly addresses this issue for direct distributions to charities,[19] there is no similar guidance for these payments. However, we understand that informal IRS position is that these payments similarly would count towards a participant's required minimum distributions for purposes of Code section 401(a)(9).

- *Does this provision violate state anti-alienation provisions on plan benefits?* To the extent that this provision is implemented prior to the plan document or statute permitting it, there may be some concern that it may violate the state's anti-alienation provisions. The Code's anti-alienation provisions, although not applicable to governmental plans, are instructive, because they prohibit a direct or indirect arrangement (whether revocable or irrevocable) whereby a party acquires a right or interest enforceable against the plan.[20] In this case, the third party insurer does not have any right or interest enforceable against the plan for the insurance premiums, and the employee makes a specific written authorization for the payments to be paid to the insurer, which likely falls within the exceptions set forth in the regulations. Moreover, IRS Code section 402(l) expressly states that the payment is treated as a distribution and that a plan is not treated as violating the requirements of section 401(a) (which includes anti-alienation) or engaging in a prohibited transaction because of the distribution. Therefore, some take the

[16] Code § 402(l)(4)(D).
[17] Notice 2007-7, I.R.B. 2005-7, Q&A 25.
[18] Treas. Reg. § 1.401(a)(31)-1, Q&A-4.
[19] Notice 2007-7, I.R.B. 2005-7, Q&As 34-44.
[20] Treas. Reg. § 1.401(a)-13(c)(1).

position that a Code section 402(l) election is more akin to a distribution election, similar to a direct rollover to an IRA, that is revocable and should not violate these rules.[21]

- *Is a separate Code section 402(l) election required?* The only requirements under the statute are that the employee makes an election after separation from service to have amounts distributed directly to an insurer in order to pay qualified health insurance premiums. There is no indication that the election must be made directly to the employer, rather than indirectly through the vendor, as long as the election is made after separation from service. However, a number of governmental plans have taken a conservative approach and developed a special election form explaining the federal income tax implications of the election.

- *What reporting and tax withholding applies?* In order to have federal income tax withholding apply, the distribution must be a designated distribution, which expressly excludes the portion of the distribution which it is reasonable to believe is not includible in gross income.[22] Therefore, one reasonable approach is to report this amount as non-taxable and have no federal income tax withholding apply to the $3,000 distribution. However, the 2007 instructions for Form 1099-R do not make this clear. They state that no special rules apply for these payments and that box 7 can indicate distribution code "2" early distribution, known exception so section 72(t) tax is not triggered. Therefore, it appears that the employer could report this amount as a taxable distribution and withhold 20% on such amounts, even though such an approach does not appear to have been intended.

B. Purchase of Permissive Service Credit

Code section 415(n), governing the purchase of permissive service credit under governmental plans, was added to the Code by the Taxpayer Relief Act of 1997. It brought legislative clarity to an area that previously had limited guidance for governmental plan sponsors and was the subject of potentially restrictive IRS positions in some areas. The PPA retroactively amended Code section 415(n)[23] to clarify a number of issues and questions that emerged after Code section 415(n) was enacted and subsequently modified in 2001 by EGTRRA,[24] including the following:

- *Purchase of Service Credit by Participants.* Prior to the PPA only "employees" were eligible to purchase service credit under Code section 415(n). The PPA clarified that all "participants" – whether or not active employees – are eligible to purchase service credit under Code section 415(n).[25]

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[21] See Treas. Reg. § 1.401(a)-13(c)(2)(iv) (direct plan to plan transfer is not an assignment).
[22] Code § 3405(e)(1)(B)(ii).
[23] PPA § 821.
[24] Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16 (Jun. 6, 2001).
[25] Code § 415(n)(1).

- *Buy-Ups*. Many governmental plans have levels or tiers of benefits for their members. Eligibility for these tiers can vary based on a member's date of hire, occupational classification, or other attributes established by sponsoring government entities. After Code section 415(n) was enacted, a number of entities began allowing their members to "buy up" to a higher tier of benefit. However, IRS private letter rulings concluded that Code section 415(n) did not permit these "buy ups."[26] The PPA clarified that these "buy ups" – even though no new additional service is purchased and, in fact, are for periods during which service has already been credited at some level, are permitted.[27]

- *"Air Time."* As originally enacted, Code section 415(n) restricted purchases of service credit to periods of time for which (other than military service) credit had not been received. A number of governmental plans, however, allowed its members to buy additional "air time" for periods during which no service had been performed. The PPA revised Code section 415(n) to specifically permit purchases of "air time," i.e., periods during which no service is performed.[28]

- *Interaction of Nonqualified Service Credit Rules and 403(b) and 457(b) Plan-to-Plan Transfers to Purchase Service Credit*. Prior to the PPA, it was not clear whether plan-to-plan transfers from Code section 403(b) and 457(b) plans were subject to the Code section 415(n) limits on "nonqualified" (generally, non-governmental) service credit purchases. The PPA specifically exempts these transfers from the Code section 415(n) limits on "nonqualified" service credit purchases.[29]

- *Clarification of Qualified Service Credit Rules for Educational Service.* As originally enacted, Code section 415(n) permitted the purchase of "qualified" service credit (*i.e.*, service credit not subject to the five year cap on "nonqualified" service credit) for service at a school providing elementary or secondary education under state law. The PPA clarified this provision to provide that whether or not service was performed at a school providing elementary or secondary education is determined under the law of the jurisdiction where the service was actually performed.[30]

The PPA changes to the purchase of service credit rules provide significant clarity and comfort to governmental plan sponsors. As such, a number of governmental entities are now reviewing, revising, and, in some cases, expanding their purchase of service credit rules.

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[26] Priv. Lr. Ruls. 200617038 (Feb. 3, 2006); 200605018 (Nov. 7, 2005); 200411051 (Dec. 16, 2003); and 200229051 (Apr. 25, 2002).
[27] Code § 415(n)(3)(A).
[28] Code § 415(n)(3)(A).
[29] Code § 415(n)(3)(D).
[30] Code § 415(n)(3)(C)(ii).

C. Waiver of 10% Additional Tax For Certain Distributions to Public Safety Employees

The PPA amended Code section 72(t) to provide a new exception for distributions from governmental defined benefit plans, effective August 17, 2006.[31] Specifically, the 10% additional tax imposed by Code section 72(t) on early withdrawals does not apply to distributions made to a qualified public safety employee from a governmental defined benefit plan after separation from service after attaining age 50. Recent IRS guidance[32] provided some much needed clarity in this area:

- *Clarification of Eligibility Rules*. The exception only applies if the distribution is received after separation from service, and the separation from service occurred during or after the calendar year in which a qualified public safety employee attains age 50.[33]

- *Determination of Qualified Public Safety Employee Status*. The Code section 72(t) exception applies to an employee of a state or of a political subdivision of a state (*i.e.*, a county or city) whose principal duties include services requiring specialized training in the area of police protection, firefighting services or emergency medical services for any area within such jurisdiction.[34]

- *Impact on Existing Periodic Payment Arrangements*. The exception applies to all distributions made after August 17, 2006; if payments that commenced before such date as substantially equal payments are later modified, the recapture tax applies to the pre-Aug. 18, 2006 payments, but the remaining payments may qualify.[35]

- *Not Applicable to Amounts Rolled Over to Other Plans*. The exception does not apply if the payments are rolled over from a governmental defined benefit plan to an IRA or defined contribution plan (*i.e.*, the relief does not "follow the money").[36]

- *Reporting to the IRS*. A distribution eligible for the exception is reported on Form 1099-R, using code 2 (early distribution, exception applies) in box 7. However, code 1 (early distribution, no known exception) can be used if the payer does not know whether the exception applies (which would result in the employee addressing the 10% tax issue on his Form 1040).[37]

A number of questions remain unresolved:

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[31] PPA § 828.
[32] Notice 2007-7, I.R.B. 2005-7.
[33] Notice 2007-7, I.R.B. 2005-7, Q&A-7.
[34] Notice 2007-7, I.R.B. 2005-7, Q&A-6.
[35] Notice 2007-7, I.R.B. 2005-7, Q&A-8.
[36] Notice 2007-7, I.R.B. 2005-7, Q&A-9.
[37] Notice 2007-7, I.R.B. 2005-7, Q&A-10; 2007 Form 1099-R, Instructions, p. R-11.

- *Does an employee have to be a "qualified public safety employee" at the time of his or her separation from service?* The IRS guidance does not clearly address whether the participant had to be a "qualified public safety employee" at the time of separation, though that is the rule for the $3,000 insurance premium distribution provision for "public safety officers" discussed above.[38] Future guidance may provide further clarification.

- *How does this rule apply to deferred retirement option plans (DROP)?* The IRS has issued very limited advice on DROP plans.[39] Further, there are a variety of types of DROP plans – defined benefit-style, defined contribution-style, and Code section 414(k) style, for example. As such, it is not clear whether the IRS would permit this rule to be applied to all DROPs, some DROPs, or none at all, although reasonable arguments may be made in this area.

- *Does a governmental plan have to revise its distribution forms and notices?* Governmental plans are subject to the Code section 402(f) notice rules that a participant receiving an eligible rollover distribution be provided a notice of his or her rights with respect to the distribution. The IRS has previously issued a model Code section 402(f) for plan sponsors to adopt.[40] However, this notice has not been updated recently (although we understand that the IRS is working on a more updated version). Governmental plan sponsors should evaluate whether or not to add language to their notice addressing this PPA change.

D. Relief from the Required Minimum Distribution Rules

In 2004, the IRS issued final regulations under Code section 401(a)(9), which requires that plan participant's receive required minimum distributions from their qualified plans no later than the April 1 following the later of a participant's reaching age 70½ or retirement.[41] Before the required minimum distribution regulations were finalized, governmental plans and their representatives submitted a number of comments to the IRS requesting that the IRS provide special treatment for the unique and varied benefit options provided by governmental plans. In response, the IRS provided transition guidance for governmental plans (and certain other plans), that ran through 2005.[42] In addition, the regulations grandfather annuity distribution options in effect on April 17, 2002 if they satisfy reasonable and good faith interpretations of section 401(a)(9).[43]

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[38] Notice 2007-7, I.R.B. 2005-7, Q&A; Code § 402(l)(4)(B).
[39] See e.g., Rev. Proc. 2005-16, I.R.B. 2005-10 (Mar. 7, 2005) (no advisory letter on a governmental plan that includes a drop provision).
[40] Notice 2002-3, 2002-1 C.B. 289 (Jan 13, 2002).
[41] T.D. 8987, I.R.B. 2002-19, 825 (May 13, 2002). Required minimum distribution rules for defined benefit plans were reproposed at this time and subsequently finalized in 2004. T.D. 9130 (Jun. 14, 2004).
[42] Notice 2003-2; 2003-2 I.R.B. 2003-2 (Dec. 20, 2002); T.D. 9130 (Jun. 14, 2004).
[43] Treas. Reg. § 1.401(a)(9)-6, Q&A 16.

Despite this transition flexibility, a number of governmental plans and their sponsors felt that their plan terms, some of which were arguably protected by state contract or constitutional law provisions, would still need to be changed to comply with the final regulations and continued with legislative efforts to modify Code section 401(a)(9) for governmental plans. This legislative effort resulted in a PPA provision, effective August 17, 2006, directing Treasury to issue regulations providing that a governmental plan is treated as complying with the minimum distribution rules, for all years that such rules are applicable, if it complies with a reasonable, good faith interpretation of those requirements.[44] Although regulations have not yet been issued, it appears that governmental employers need not follow the final 2002 regulations, but rather may follow the 1987 proposed regulations, proposed 2001 regulations, or another approach that is a reasonable, good faith interpretation of the statute.

E. Relief from the Nondiscrimination Rules

State and local government plans have long been exempt from nondiscrimination rules under Code section 401(a)(4).[45] All other governmental employers, however, were covered by a moratorium until the first plan year beginning on or after final 401(a)(4) regulations were issued.[46] The PPA expanded this limited exemption from nondiscrimination testing to all governmental entities – including governmental entities that are neither state or local governmental entities – effective August 17, 2006.[47] The exemption covers the nondiscrimination and minimum participation rules under Code sections 401(a)(4), 401(k), 401(m) and 401(a)(26). As such, for example, no grandfathered governmental 401(k) plan needs to perform actual deferral percentage testing under Code section 401(k) (or testing on the related match) and there is no longer a minimum 50 participant requirement for defined benefit plans.

F. Indian Tribal Governmental Plans

Code section 414(d) provides a definition for the term "governmental plan." Further, the IRS is currently working on a guidance project that may result in regulations helping to further define the term "governmental plan." A long-standing question has been the extent to which an Indian tribal government qualified as a governmental plan under ERISA and the Code. The PPA addresses this issue, effective August 17, 2006, by providing that the term "governmental plan" includes a plan established or maintained by an Indian tribal government for its employees performing governmental functions and not commercial activities.[48] Transition guidance issued by the IRS after the PPA provides rules allowing an Indian tribal government to transition its non-governmental function employees into a non-governmental plan.[49] This transition guidance summarizes the PPA amendments to Code section 414(d) and provides good faith compliance rules for Indian

[44] PPA § 823.
[45] Taxpayer Relief Act of 1997, § 1505(d)(2), P.L. 105-34 (Aug. 5, 1997).
[46] Notice 2003-6, 2001-12 CB 298 (Dec. 20, 2002); Notice 2001-46, 2001-2 CB 122 (Jul. 18, 2001).
[47] PPA § 861.
[48] PPA § 906.
[49] Notice 2006-89, IRB 2006-43 (Oct. 3, 2006).

tribal government plan sponsors with plans covering employees providing both essential government functions and commercial activities. Also, we understand that the IRS, DOL and PBGC are working on developing a coordinated approach to defining "governmental plan" for their respective regulatory purposes.

II. PPA Provisions of General Applicability

A number of the PPA provisions apply equally to governmental plans and private sector plans. Some of the broadly applicable PPA provisions that are of special interest to governmental plans are described below.

A. Non-Spouse Beneficiary Rollovers

Public plans typically limit payments to non-spouse beneficiaries to lump sum payments. These amounts were immediately taxable to the beneficiaries, with no opportunity to rollover the payment to a tax-deferred arrangement. To provide some additional parity between spousal beneficiaries and non-spouse beneficiaries, the PPA expanded the eligible rollover provision to allow limited rollovers to non-spouse beneficiaries. Specifically, effective January 1, 2007, the PPA added a provision in Code section 402(c)(11), permitting a direct trustee-to-trustee transfer of any portion of an eligible rollover distribution (determined as if the payment was made to an participant) from an eligible retirement plan to a traditional inherited IRA for a non-spouse designated beneficiary.[50]

The key features are summarized below, with recent IRS guidance providing some much needed answers to plan sponsors and IRA providers.[51]

- *Optional Feature*. Plans are not required to offer non-spouse beneficiary rollovers; it is purely optional. Governmental employers, unlike other employers, can also offer this option on a discriminatory basis because they are not subject to nondiscrimination rules. However, if this provision is offered, the plan document should be amended to reflect the provision by the end the PPA amendment period (generally last day of the 2011 plan year).

- *Eligible Plans*. The feature is available to the following plans – Code section 401(a), 403(a), 403(b), and governmental 457(b) plans.

- *Direct Rollovers Only*. Only direct rollovers are covered under the non-spouse beneficiary rollover rule. Therefore, if the beneficiary receives the amounts, the feature is not available; indirect rollovers are not permitted.

- *Eligible Rollover Distribution*. The distributed amount must satisfy all of the requirements to be an eligible rollover distribution other than the requirement that the distribution be made to the participant or the participant's spouse.

[50] PPA § 829.
[51] Notice 2007-7, I.R.B. 2005-7.

Thus, for example, annuity distributions, minimum required distributions, and installments over a specified period of 10 or more years are all ineligible for this rollover treatment.

- *Designated Beneficiary*. The non-spouse beneficiary must be a designated beneficiary under the minimum required distribution rules.[52] Thus, the non-spouse beneficiary must be designated either by the terms of the plan or by an affirmative election by the participant or the participant's surviving spouse. The beneficiary must be an individual or a trust that meets the minimum required distribution requirements for trusts as beneficiaries.[53] This provision does not extend to non-spouse alternate payees under a QDRO.

- *Inherited IRA*. The IRA must be established in a manner that identifies it as an IRA with respect to a deceased individual, and also identifies the deceased individual and beneficiary, for example, "Tom Smith as beneficiary of John Smith".

- *Not an Eligible Rollover Distribution for other Purposes*. A direct non-spouse beneficiary rollover is not a rollover for purposes of (1) the default IRA rollover provisions,[54] (2) the rollover notice requirements,[55] or (3) 20% mandatory withholding.[56] Although there is no requirement to give a rollover notice to a non-spouse beneficiary, it is likely that some employers may add a description of this provision as part of their regular rollover notice. Also, some employers have developed a separate form to request this rollover. In any event, if non-spouse beneficiary rollovers are offered, an employer and/or its service providers may need to revise their forms and system operations.

- *MRD Rules*. The IRA of the non-spouse beneficiary must follow the minimum required distribution rules for inherited IRAs. Thus, if a participant dies before his or her required beginning date (generally the later of April 1 following the later of his or her attaining 70½ or retiring), the inherited IRA must distribute all amounts under either the 5-year rule (generally, by the end of the 5th calendar year following the year of the participant's death), or the life expectancy rule (generally distributions commencing in the year following the year of the participant's death over the life expectancy of the beneficiary). Consequently, the application of these rules is fairly straightforward where a distribution is a lump sum. Where a distribution from the deceased participant's plan is in installments over less than 10 years, installments distributed from the employee's plan after the end of the 5-year period under the 5-year minimum required distributions rule cannot be rolled over. If payments are distributed from a participant's plans in annuity form or installment of 10 years or more, they are not eligible rollover distributions and

[52] Code § 401(a)(9)(E); Treas. Reg. § 1.401(a)(9)-4.
[53] Treas. Reg. § 1.401(a)(9)-4, Q&A-5.
[54] Code § 401(a)(31)(B).
[55] Code § 402(f).
[56] Code § 3405(c). Instead, 10% voluntary withholding would apply.

cannot be transferred to a non-spouse beneficiary IRA.[57] Undistributed required minimum distributions for the year of the direct rollover and all prior years cannot be rolled over.

If the employee dies on or after his or her required beginning date under Code section 401(a)(9), only amounts that would be eligible rollover distributions (*e.g.*, not any minimum required distribution amounts or annuity amounts) may be rolled over to a non-spouse beneficiary IRA, and distributions from that IRA must be made as rapidly as required under the minimum required distribution rules – generally, at least as rapidly as the applicable distribution period that would have applied under the employee's plan if the direct rollover had not occurred.[58]

Although the IRS guidance was very helpful, it failed to address a number of issues that continue to be raised by governmental (and other) employers. For example,

- *Are multiple rollovers permitted?* Specifically, whether a single inherited IRA can accept non-spouse beneficiary rollovers from multiple plans or IRAs of the same decedent? How do these rules work with multiple beneficiaries?

- *Can this option be limited to lump sum distributions made in the year of death to a sole beneficiary?* Some plan sponsors have expressed an interest in limiting their administrative and/or systems changes, and thus would like to to limit the availability of these rules.

- *What information must the plan's administrator furnish to the IRA provider?* For example, to what extent does an IRA issuer need to interface with the provisions of a plan for purposes of minimum required distribution calculations, because the IRS guidance generally requires the use of the same minimum required distribution period as under the plan? Must the plan administrator provide this information to the sponsor of the inherited IRA? Or should the non-spouse beneficiary be required to obtain this information or otherwise certify the proper period? Hopefully, reasonable rules can be developed to simply these transfers, and limit the amount of information exchange that is necessary.

B. Rollover of After-Tax Amounts Between Qualified Plan and 403(b) Plans

EGTRRA enhanced pension portability by introducing the concept of rollover of after-tax contributions. Following EGTRRA, participants were able to directly roll over after-tax contributions in a Code section 401(a) plan into a traditional IRA and defined contribution plan that agrees to separately account for these amounts. The PPA further liberalized these rules to provide even more portability than offered under EGTRRA.

[57] Notice 2007-7, I.R.B. 2005-7, Q&A 15.
[58] Code § 401(a)(9)(B)(i).

Specifically, the PPA amended the Code, effective January 1, 2007, to permit direct rollovers of after-tax amounts from a Code section 401(a) qualified retirement plan into a defined contribution plan, defined benefit plan, or Code section 403(b) plan, provided that the plan separately accounts for such contributions and earnings thereon.[59] This provision is not optional. Plan sponsors might consider amending their rollover distribution notice to reflect this provision.

However, the reverse situation – rollovers of after-tax Code section 403(b) contributions into a qualified plan – remains unclear. The IRS' post-EGTRRA guidance[60] provides a sample amendment which does not provide for rollovers of after-tax contributions, if any, from a Code section 403(b) plan or governmental Code section 457(b) plan because the Conference Report only discusses qualified plans. However, IRS staff has informally indicated that a plain reading of the statute (prior to any technical correction) would permit rollovers of such amounts.[61] Subsequent EGTRRA technical correction legislation[62] did not include any technical corrections on this issue. However, the model rollover distribution notice does not reflect this option – it only expressly permits rollovers of after-tax 403(b) amounts to another 403(b) plan.[63] Moreover, the explanation of the PPA also indicated that the current law only provides for rollover of after-tax amounts between 403(b) plans.

The PPA did not clarify this provision – it only expressly addressed after-tax payments from a qualified plan to a 403(b) plan. Thus, although the issue remains unclear, a reasonable position may be to accept after-tax Code section 403(b) amounts into a Code section 401(a) plan, provided the contributions (and earnings thereon) are separately accounted for.

C. Deferred Retirement Option Plans and Cash Balance Guidance

As noted above, DROPs exist in a number of forms – defined benefit-style DROPs, defined benefit DROPs, and Code section 414(k)-style DROPs, for example. The PPA adds a number of provisions to the Code governing cash balance and individual account-style defined benefit plans.[64] A number of existing DROPs may fall within these new individual account rules, thus adding complexity for governmental DROP sponsors. It is not clear whether the IRS will provide any exemption for governmental DROPs when it is issues guidance under these provisions later this year.

D. Timing of Tax Notices for Eligible Rollover Distributions

A participant entitled to an eligible rollover distributions (*e.g.*, lump sum distribution) must receive an explanation of the tax and rollover rules applicable to such

[59] PPA § 822.
[60] Notice 2001-57, I.R.B. 2001-38, 279 (Aug. 31, 2001).
[61] Code §§ 457(e)(16)(B), 403(b)(8)(B).
[62] Job Creation and Worker Assistance Act of 2002, P.L. 107-14 (Mar. 9, 2002).
[63] Notice 2002-3, 2002-1 C.B. 289 (Jan 13. 2002).
[64] PPA §§ 701 and 702.

distribution.[65] Prior to the PPA, this notice (or a summary thereof) was required to be provided within the 90 days prior to a distribution.[66] The PPA extends the 90 day period to 180 days, providing additional flexibility for distribution packages.[67] This provision applies to notices distributed in a plan year that begins after December 31, 2006.[68]

E. Phased Retirement and In-Service Distributions

Historically, pension plans (including money purchase pension plans) have been prohibited from making in-service distributions to participants.[69] However, the IRS began to provide some relief in this area with the issuance of proposed "phased retirement" regulations that (1) would allow pension plans to pay benefits prior to an employee's normal retirement age, even if still working, and (2) permit a pro rata portion of a plan benefits to be distributed based on a reduced work schedule.[70] Effective for distributions made in plan years beginning after December 31, 2006, the PPA added a new Code section 401(a)(36) that for the first time expressly permits in-service distributions under a pension plan on or after the participant has reached age 62. Many plan sponsors are now waiting for additional guidance from the IRS reflecting the interaction of Code section 401(a)(36), the proposed "phased retirement" regulations, and other applicable rules. Recently, the IRS provided guidance on what is an appropriate "normal retirement age" that adds to these issues.[71]

F. Waiver of 10% Additional Tax For Certain Distributions to Employees in Military Service

Distributions from a tax-qualified arrangement are generally subject to a 10% early withdrawal tax if made prior to the participant reaching age 59½. Moreover, elective deferrals under a Code section 401(k) or 403(b) plan (and all contributions under a Code section 403(b)(11) contract) are generally not available until the participant reaches age 59 ½, dies, terminates employment, becomes disabled, or has a financial hardship.[72] Therefore, reservists called to active duty that needed additional funds were potentially precluded from taking sufficient distributions from their benefit plan (due to the tax implications), or otherwise subject to an additional 10% tax on their distributions.

To alleviate this hardship, the PPA provides special relief for early withdrawals made after September 11, 2001.[73]

- *Relief from 10% Tax*. The 10% additional tax does not apply to a "qualified reservist distribution," which is defined as any distribution to an individual if:

[65] Code § 402(f); Treas. Reg. § 1.402(f)-1.
[66] Treas. Reg. § 1.402(f)-1, Q&A-2.
[67] PPA § 1102.
[68] Notice 2007-7, q&A-31.
[69] Treas. Reg. § 1.401-1(b).
[70] Reg. 114726-04 (Nov. 10, 2004).
[71] T.D. 9325 (May 21, 2007).
[72] Code §§ 401(k) and 403(b).
[73] PPA § 827.

(1) the distribution is from an IRA, elective deferrals under a Code section 401(k), 403(b) or 501(c)(18)(D)(iii) plan, (2) the individual was, by reason of his being a member of a "reserve component",[74] ordered or called to active duty for (i) a period in excess of 179 days, or (ii) an indefinite period, and (3) the distribution is made during the period beginning on the date of the call or order to active duty and ending at the close of the active duty period.[75]

As this provision applies retroactively, a special additional one-year statute of limitations period applies for a refund or credit of overpaid taxes.[76]

- *Distributable Event for Elective Deferrals*. The PPA provides that a "qualified reservist distribution" can be made without violating the distribution restrictions otherwise applicable under Code sections 401(k) and 403(b).[77]

- *Repayment of Qualified Reservist Distributions*. Any individual who receives a "qualified reservist distribution" may make one or more contributions to his IRA, without regard to the IRA contribution limits, provided that:[78]

  - The aggregate amount repaid to the IRA does not exceed the original military distribution; and

  - The contribution is made within the 2-year period beginning on the day after the end of the active duty period (or Aug. 17, 2008, if later)

  The IRA contribution is not deductible.[79] Upon distribution of the repayment, presumably it is treated as a tax-free distribution to the extent that the military distribution was subject to taxation.

Although governmental employers are generally eager to provide for this relief (even though it is currently set to expire for reservists called to active duty after this year (unless various legislative proposals are enacted)), several questions have arisen regarding implementation.

- *What are the applicable reporting and withholding requirements?* The 2007 1099-R Instructions expressly indicate that code 1 in box 7 should be used for qualified military distributions under Code section 72(t)(2)(G) – early distribution, no known exception. Presumably, the IRS intends that the burden will be on the participant to explain why the 10% tax does not apply with his or her tax return filing.

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[74] As defined in 37 USC § 101.
[75] Code § 72(t)(2)(G).
[76] PPA § 827(c)(2); IRS News Release 2006-152.
[77] Code §§ 401(k)(2)(B)(i)(V), 403(b)(7)(A)(ii), and 403(b)(11)(C).
[78] Code § 72(t)(2)(G)(ii).
[79] *Id.*

The applicable withholding rate for a qualified reservist distribution is unclear. If a distribution was allowed to be treated as a hardship distribution, then a 10% federal income tax withholding rate would apply, unless the participant elects an alternative level of federal income tax withholding. However, without IRS guidance, some may conclude that qualifying reservist distributions would be an eligible rollover distribution, resulting in a mandatory 20% withholding rate.[80]

- *Can the in-service military distribution be made from a Code section 457(b) plan?* No. This provision does not apply to distributions from a Code section 457(b) plan because a qualified reservist distribution only includes distributions from an IRA, or elective deferrals under a Code section 401(k) plan (or a Code section 501(c)(18)(D)(iii) or Code section 403(b) plan).

- *Can the distribution be rolled over (directly or indirectly) to an IRA or other eligible retirement plan?* Although it appears that the payment meets the definition of an eligible rollover distribution, this result may not have been intended. Future guidance may provide additional clarity.

- *What type of evidence is required to make the distribution?* Some employers are requesting a copy of the participant's activation papers, or, at a minimum, a representation that they meet the requirements for a distribution. As the distribution is a plan qualification issue, the more evidence that the plan can show that the distribution was proper is advisable. A special distribution form may also be developed for this purpose.

III. Conclusion

Many PPA provisions are of direct and significant impact on governmental plans and their sponsors. A number of these changes provide unique new plan features that governmental plan sponsors may wish to add to their plans. With these changes, however, there are new levels of complexity that should be carefully considered. As such, governmental plan sponsors should carefully review the PPA provisions that apply to them to determine which they must or desire to add to their plans.

[80] Treas. Reg. § 1.402(c)-2, Q&A-3.