retirement
plan news

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The Nonspouse Beneficiary Rollover Rules

The Pension Protection Act of 2006 (PPA) permits the nonspouse beneficiary of a participant in a qualified plan, Section 403(b) arrangement, or governmental Section 457(b) plan to make a direct rollover of the deceased participant's plan balance to an inherited IRA.*

This new provision is effective for distributions that occur after December 31, 2006. The IRS issued initial administrative guidance for this law change in Q&A format in Notice 2007-7. To further clarify the guidance, the IRS subsequently published a special edition of its online newsletter, *Employee Plan News.*

Since the nonspouse rollover is a new, somewhat complex concept, this article untangles the issues involved, one at a time.

Direct Rollover Rules. An inherited IRA may only be established by a direct rollover. *If a plan distribution is paid directly to a nonspouse beneficiary, the distribution is not eligible for rollover.*

The IRS guidance states that nonspousal direct rollovers are not subject to the usual direct rollover requirements, such as the mandatory 20% withholding on amounts not directly rolled over, nor is the 402(f) rollover notice required. In addition, plans are *not* required to offer nonspouse beneficiary direct rollovers. However, *a terminating defined contribution plan must offer direct rollovers to nonspouse beneficiaries regardless of existing plan terms.*

Inherited IRA Title. The IRA must be identified explicitly as an IRA with respect to a decedent, and the names of both the decedent and the beneficiary must be included in its title; for example, "Mary Jones as beneficiary of John Smith."

Trust as Beneficiary. A direct rollover to an inherited IRA on behalf of a beneficiary of a trust is permitted provided the beneficiary qualifies for designated beneficiary status within the meaning of the required minimum distribution (RMD) rules. In such a situation, the IRA must be established with the trust as beneficiary, and the distribution period must be based on the life expectancy of the beneficiary of the trust.

Required Minimum Distributions. The guidance in Notice 2007-7 generally reiterates the RMD rules for beneficiary payouts with certain changes necessary for handling the new nonspouse beneficiary rollover. Note that, as usual, the options available to a beneficiary are dependent upon whether death occurs before or after the participant's required

beginning date (RBD, the deadline for receiving the first RMD), and on the qualified plan document provisions.

Death before participant reaches RBD. If a participant dies before his or her RBD, the amount eligible for rollover with respect to a nonspouse beneficiary is determined under either the five-year rule or the life expectancy rule, as set forth in the distributing plan.

- **Five-year rule.** If the plan has elected the five-year rule, a nonspouse benefici-

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* It is important to remember that this is the Federal tax law. Therefore, under the Federal Defense of Marriage Act, same-sex partners can never be considered spouses, even if they are married under applicable state laws.

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ary may make a direct rollover at any time during the first four years after the year of the participant's death. However, no amounts may be rolled over on or after January 1 of the fifth year following the year in which the participant died. If there are any undistributed RMD amounts (for the year in which the rollover occurs and any prior year), those amounts are not eligible for rollover. Under the five-year rule, all benefits must be distributed by the receiving IRA to the beneficiary by the end of the fifth year after the year of death.

- **Life expectancy rule.** Under the life expectancy rule, the single life expectancy table is used to determine the distribution period for the nonspouse beneficiary. Again, undistributed RMDs (for the year in which the rollover occurs and any prior year) are not eligible for rollover. The rollover to the IRA must occur before the end of the calendar year following the year of death.
- **Special rule (overrides five-year rule).** If the five-year rule applies, the nonspouse designated beneficiary may elect to use the life expectancy method for determining RMDs instead, *provided the direct rollover occurs before the end of the year following the participant's year of death.* If this option is elected, the newly established inherited IRA must make RMDs based on the beneficiary's life expectancy.

Death on or after participant's RBD. If a participant dies on or after their RBD, the RMD for the year of death must be paid based on the amount that would have been payable had the participant lived and elected a direct rollover. Thus, the nonspouse beneficiary may directly roll over the amount above the RMD for the year to an inherited IRA. Similarly, for years *after* the year of death, if there are any undistributed RMDs (for the year of the direct rollover, or any prior year, including years before the employee's death), those amounts are *not* eligible for rollover.

RMDs for nonspouse beneficiaries after rollover to an inherited IRA. *An IRA established to receive a direct rollover on behalf of a nonspouse designated beneficiary is treated as an inherited IRA.* The above statutory and regulatory RMD requirements continue to apply to the inherited IRA. If the individual making the inherited IRA rollover has another IRA, he or she may follow another RMD option for those funds (when required).

Clarifications. PPA provided that distributions to a nonspouse beneficiary made after December 31, 2006, may be rolled over to an inherited IRA. Generally, the first major limitation the IRS guidance added was to require that the funds be moved by direct rollover, thus prohibiting the beneficiary from taking cash and completing the rollover within 60 days. This may have been to prevent mistakes or abuse and to avoid invalid rollovers.

Although it was provided that distributions from the inherited IRA were to conform to the RMD elections under the plan, the special rule was added to allow beneficiaries subject to the five-year rule to shift to the life expectancy method (as explained earlier). The IRS issued follow-up guidance to confirm the special rule.

Further, the IRS added that a rollover must be made within the first four years of the five-year period and not in the fifth year. This makes sense because RMDs are calculated based on the preceding December 31 balance, and receiving organizations don't track rollovers for distribution calculation purposes until a December 31 has passed. So, if the funds are rolled over in the fifth year, the funds would not be included in an RMD calculation program because they were not there on the preceding December 31. ❖

"Fiduciary Advisers" Under PPA

A fiduciary adviser is a person who is a plan fiduciary because he or she provides investment advice to plan participants or beneficiaries. In addition, the fiduciary adviser must be one of the following:

1. Registered as an investment adviser under the Investment Advisers Act of 1940 or under the laws of the state in which it maintains its principal office and place of business.
2. A bank or similar financial institution or savings association, but only if the advice is provided through a trust department that is subject to periodic examination and review by federal or state banking authorities.
3. An insurance company qualified to do business under the laws of a state.
4. A person registered as a broker or dealer under the Securities Exchange Act of 1934.
5. An affiliate of a person or entity in one through four.
6. An employee, agent, or registered representative of a person in one through five who satisfies the requirements of applicable insurance, banking, and securities laws relating to the provision of investment advice. ❖

One of the things plan participants frequently ask for is more investment advice. However, plan service providers and plan sponsors have been reluctant to make such advice available because of concerns about fiduciary liability. The Pension Protection Act of 2006 (PPA) permits retirement plan service providers who offer investments to participant directed plans (fiduciary advisers) to provide investment advice, and, if warranted, to recommend their own funds without violating fiduciary rules.

In general, PPA grants prohibited transaction exemptions for investment advice provided by fiduciary advisers after December 31, 2006, under an "eligible investment advice arrangement" (EIAA). To qualify for this relief, an eligible investment advice arrangement must meet certain conditions. *Either* the fiduciary adviser's fees must be "neutral" (meaning that the fees the adviser receives are the same, regardless of which investment options a participant chooses after receiving advice) *or* the adviser must use an unbiased computer model, certified by an independent expert, to create a recommended portfolio for a participant's consideration. (Note that those offering computer models will now be deemed to be plan fiduciaries as well.)

More PPA Rules. Before investment advice may be given, the fiduciary adviser must provide the participant with a written or electronic notice.

The fiduciary adviser must also maintain records demonstrating compliance with the various rules for fiduciary advisers for six years.

Beginning in 2007, eligible investment advice arrangements will have to comply with a *new* annual independent compliance audit. This requirement, which is unrelated to the Form 5500 independent audit, requires that an audit report be provided to the plan fiduciary that authorized the investment advice arrangement.

Plan assets may be used to pay reasonable expenses involved in providing investment advice under these rules.

Notice Requirements

Under PPA, fiduciary advisers must provide participants with a written or electronic notice *before* any advice is provided. The notice must include:

- **The role of any related party in developing the advice program or selecting plan investment options,**
- **The past performance and rates of return for each of the plan's investment options, and**
- **A disclosure of any fees or other compensation to be received by the fiduciary adviser.**

Guidance from the DOL. The DOL recently issued FAB 2007-1, which addresses three issues involving EIAAs.

1. DOL guidance on investment advice issued prior to PPA continues to apply.
2. The standards of fiduciary care and prudence that applied prior to PPA are required when using an EIAA — with the additional PPA requirements. Plan fiduciaries have a duty to prudently select and periodically monitor the advisory program, but not the advice given. As long as these guidelines are followed, the fiduciary is not responsible for the advice provided by the fiduciary adviser. The FAB provides a process for the prudent selection and monitoring of fiduciary advisers.
3. The investment advice exemption applies only to investment advice provided by a fiduciary adviser under an EIAA and not to affiliates of the fiduciary adviser. The DOL view is that Congress did not intend for the neutral fee requirement to extend to the affiliate of a fiduciary adviser — unless, of course, the affiliate also provides investment advice. For example, if a participant chooses to invest in an affiliate of a fiduciary adviser, *and the fiduciary adviser has not provided investment advice about the affiliate*, then the fees charged by the affiliate do not have to meet the neutral fee requirement.

The DOL further clarifies that PPA also permits employees,

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recent developments

Cash Balance Plans. The U.S. Supreme Court declined to review the 7th U.S. Circuit Court of Appeals' favorable decision in the IBM cash balance plan case. This effectively upholds the lower court's decision. The IRS recently opened a review procedure for cash balance plans that were converted from traditional defined benefit plans before June 29, 2005, and issuing determination letters for these cash balance plans is a high priority for the Service. Separate determination letters will be simultaneously issued, as appropriate, for both GUST and EGTRRA Cycle A and Cycle B determination letter applications. While the story isn't over yet, cash balance plans are clearly here to stay.

Benefit Statements. Under PPA, defined benefit plans generally are required to furnish participants with a pension benefit statement at least once every three years. The first statement complying with the new requirements will be due for the 2009 plan year, unless a plan elects to comply with the alternative notice requirement. Under the alternative notice requirement, the statement requirements are met if, at least annually, the DB plan administrator provides participants with a notice stating that a current pension benefit statement is available and informing them of how they may obtain a statement. To avoid the three-year statement requirement, the first alternative notice must be furnished by December 31, 2007. ❖

Prohibited Transaction Exemption Rules... *(Continued from page 3)*

agents, or registered representatives of fiduciary advisers who provide investment advice in their capacity as employees, agents, or registered representatives to qualify as fiduciary advisers, provided they satisfy the relevant advice requirements of applicable insurance, banking, and securities laws. Thus, both the individuals and the entity they work for are fiduciary advisers. Employers should expect that more investment providers will agree to step into the role of fiduciary adviser than had previously been the case. ❖

The general information in this publication is not intended to be nor should it be treated as tax, legal, or accounting advice. Additional issues could exist that would affect the tax treatment of a specific transaction and, therefore, taxpayers should seek advice from an independent tax advisor based on their particular circumstances before acting on any information presented. This information is not intended to be nor can it be used by any taxpayer for the purpose of avoiding tax penalties.

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