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IRS Offers Insight on Recent Guidance Relating to Retirement Plan Distributions

November 2009

Recently, the Internal Revenue Service (the "IRS") hosted a phone forum (the "IRS Phone Forum") during which IRS representatives discussed certain of the guidance issued this fall that relate to retirement plan distributions and addressed practitioner questions.

This alert summarizes the content of the IRS publications listed below, and, where applicable, highlights the comments made by IRS representatives during the recent IRS Phone Forum:

- Notice 2009-82 – Required Minimum Distribution Rules
- Revenue Ruling 2009-31 – Annual Paid Time Off Contributions
- Revenue Ruling 2009-32 – Paid Time Off Contributions at Termination of Employment
- Notice 2009-68 – Safe Harbor Explanation – Eligible Rollover Distributions
- Notice 2009-75 – Roth IRAs – Rollovers From Employer Plans

Required Minimum Distributions

Section 401(a)(9) of the Internal Revenue Code of 1986, as amended (the "Code") and the Treasury regulations thereunder, require that participants in tax-qualified retirement plans generally begin taking required minimum distributions ("RMDs") by the April 1st following the calendar year in which they attain age 70 ½ or, if later, the year in which they retire from the plan sponsor, with certain limited exceptions for 5% owners. The amount of the annual RMD from a defined contribution plan or an IRA is determined by dividing the account balance as of the last day of the prior year by a factor from the applicable table published in Treasury Regulation Section 1.401(a)(9)-9. Failure to take a required minimum distribution can expose the plan sponsor and the participant to significant tax penalties.

Worker, Retiree and Employer Recovery Act Suspends 2009 RMDs. The Worker, Retiree and Employer Recovery Act of 2008 ("WRERA") waives the requirement that RMDs be made from defined contribution plans (and IRAs) for 2009. However, because of ambiguities in the statute and a lack of subsequent guidance, there were many uncertainties, including, for example, whether the RMD waiver was required or simply permitted, how to report and withhold on distributions that would have otherwise have been considered RMDs for 2009, and whether such distributions are eligible rollover distributions.

Notice 2009-82. On September 24, 2009, the IRS issued Notice 2009-82, which provides guidance on the waiver of 2009 RMDs, including transition relief through November 30, 2009, rollover relief, additional information in the form of Q&As, and sample amendments.

Transition Relief Through November 30, 2009. Notice 2009-82 provides that there is no operational failure if a plan was not operated in accordance with its terms regarding RMDs and related payments between January 1, 2009 and November 30, 2009 because the plan:

- did not make distributions that are equal to 2009 RMDs, or distributions that are part of a series of substantially equal distributions that would have included 2009 RMDs;

- did not give participants and beneficiaries the option to receive or not receive distributions that include 2009 RMDs; and
- did not give participants the option of rolling over distributions that otherwise would have been 2009 RMDs.

Amending the Plan. WRERA requires that plans be amended to reflect the treatment of 2009 RMDs and related payments no later than the last day of the first plan year beginning on or after January 1, 2011 (January 1, 2012 for governmental plans) (the “Amendment Deadline”). Notice 2009-82 provides two alternative sample amendments that may be used by plan administrators to reflect the operation of their plans for 2009. One of the amendments provides that the plan will make 2009 RMDs and the other provides that the plan will not make 2009 RMDs, unless, in either case, the participant affirmatively elects otherwise. The amendments also include language regarding the direct rollover treatment of 2009 RMDs.

Plan sponsors may use either amendment regardless of their current plan language, and the sample amendments may be modified to reflect the plan’s terms and administrative procedures. In the IRS Phone Forum, IRS representatives indicated that in deciding which amendment to adopt, a plan administrator may interpret the plan in a reasonable manner and then amend the plan to reflect the operation, even if the operation changes. Plan administrators should notify participants of, and provide them with the means to exercise, their right to elect to receive, or not receive, as applicable, 2009 RMDs. However, the IRS is not mandating any specific way in which such notification is to be provided or such elections be implemented. In addition, the IRS representatives said that where a plan administrator interprets a plan as providing that 2009 RMDs will not be made, the plan must allow an affected participant the right to elect to receive 2009 RMDs in order to avoid violating the anti-cutback rules. However, where a plan administrator interprets a plan as providing that 2009 RMDs will be made, there is no requirement that the plan provide affected participants with the right to elect otherwise.

Rollover Relief. Participants who have already received payments that would have been 2009 RMDs (or one of a substantially equal series of distributions that would have included 2009 RMDs) are being given an extended time period to roll over those amounts either into an eligible retirement plan or an IRA. For this purpose, a participant may roll over the amounts until the later of the 60th day following the date of distribution and November 30, 2009. In addition, because Section 201(b) of WRERA exempted amounts that would have been 2009 RMDs from the notice requirements of Code Section 402(f), plan sponsors are not obligated to issue rollover notices with respect to any such distributions.

A number of the previously unanswered questions regarding the waiver and treatment of 2009 RMDs are also presented and addressed in Notice 2009-82 in the form of Q&A guidance. Most notably, the Q&A guidance in Notice 2009-82 provides that plan distributions that include 2009 RMDs can be rolled over back into the same plan, provided the plan allows for rollover contributions and the rollover satisfies the requirements of Section 402(c) of the Code. This means that participants have until November 30, 2009, or the 60th day from the date of distribution, to roll over any 2009 RMDs previously received back into their plan. The IRS representatives noted that if a plan does not currently allow for rollover contributions, the plan may still accept the rollover of 2009 RMDs, if the plan is amended to reflect such operation no later than the Amendment Deadline.

Unused Paid Time-Off Contributions to Qualified Plans

The IRS recently issued two Revenue Rulings that address the treatment of contributions of the dollar equivalent of unused paid time-off (“PTO”) to a qualified plan in the context of annual contributions (Revenue Ruling 2009-31) and in the context of contributions on termination of employment (Revenue Ruling 2009-32). Both Revenue Rulings provide that it is permissible either to permit or mandate that employees contribute the dollar equivalent of any unused paid time-off as of a specified date to a profit sharing and/or 401(k) plan (the “Qualified Plan”), subject to the following:

- *General Rules.* In both Revenue Rulings, all employees of the employer are eligible to participate in the PTO plan on substantially the same terms and conditions, the PTO plan qualifies as a bona fide sick and vacation leave plan for purposes of the deferred compensation rules under Code Section 409A, and all payments for PTO come from the general assets of the employer.

- *Treatment of Non-Elective Contributions.* Where the PTO plan mandates that any unused PTO as of a specified date is forfeited and the dollar equivalent of the forfeited amount is contributed to the Qualified Plan, the contributions are non-elective contributions and are subject to the applicable limitations under Code Section 415(c). In addition, because the amount contributed for each participant will vary based on his or her amount of unused PTO, the arrangement will likely not satisfy the design-based safe harbor under Code Section 401(a)(4), and will require non-discrimination testing of the contributions made for individual participants.

  Because non-elective contributions to a Qualified Plan are not treated as compensation under Code Section 415(c) ("Section 415 Compensation"), plan administrators will need to monitor the mandated contribution of unused PTO contributions, especially in the context of termination of employment, to ensure that the Code Section 415(c) limits are not exceeded.

  For instance, suppose an employee terminates employment on December 28, 2009, and pursuant to the terms of the PTO plan, must contribute his unused PTO to the Qualified Plan. The unused PTO is allocated to the Qualified Plan on January 18, 2010. Because the non-elective contributions are excluded from the employee's Section 415 Compensation, he has no Section 415 Compensation for 2010, and therefore the non-elective contribution would exceed the employee's Section 415 Compensation and violate the Code Section 415 limits. This issue may be avoided (as described in Situation 2 of Revenue Ruling 2009-32), by requiring that, in the context of a termination of employment, 50% of the unused PTO must be contributed to the Qualified Plan, and the remainder will be paid to the employee as cash within 2 ½ months following the termination date or, if later, the end of the limitation year in which the termination date occurs.

Note: Because elective contributions to a Qualified Plan are generally included in Section 415 Compensation, this issue does not arise in the context of an arrangement that permits, rather than requires, employees to contribute unused PTO to a Qualified Plan.

- Application of 415 Limits. In determining whether the Qualified Plan meets the limitations under Code Section 415 for each limitation year, the contribution of unused PTO, whether elective or non-elective, is treated as credited to the account of a participant for a particular limitation year if it is allocated to the participant's account under the terms of the plan within that limitation year.

If the applicable requirements are met, the Revenue Rulings provide that requiring or permitting the contribution of the dollar equivalent of unused PTO to a Qualified Plan does not cause the Qualified Plan to fail to be a qualified plan under Code Section 401(a), and a participant does not include the contributions to the Qualified Plan in his or her gross income until distributions are made to the participant from the Qualified Plan.

During the IRS Phone Forum, the IRS representative indicated that the IRS is considering extending this feature to Code Section 403(b) plans. The IRS representative also stated that where an employer requires that unused PTO be contributed to a Qualified Plan, but allows an employee to postpone his or her termination date in order to use up some of his or her unused PTO, that would not convert the otherwise non-elective contributions into elective contributions, as it is generally within the discretion of an employee to select the termination date.

Updated Safe Harbor Distribution Notices

Code Section 402(f) requires that a plan administrator inform a recipient of an eligible rollover distribution in writing of his or her right to roll over such amounts, the tax implications of receiving the distribution (rather than rolling it over) and certain other information. The Treasury regulations provide that a plan administrator is deemed to have complied with the requirements of Code Section 402(f) if it provides the applicable model notice published by the IRS.

The IRS originally published a safe harbor notice in Notice 2002-3. Since its publication, a number of changes in the law have occurred that have made the IRS safe harbor 402(f) notice outdated, including, but not limited to (i) the existence of designated Roth contributions, as added by Code Section 402A, which are subject to special rollover requirements, (ii) the requirement that mandatory distributions in excess of $1,000 from a qualified plan under Code Section 401(a) be paid in a direct rollover to an IRA or a designated trustee or issuer in the absence of an affirmative election otherwise by the participant, (iii) the treatment of, and income inclusion required, with respect to rollover to a Roth IRA of amounts that are not from a designated Roth account (other than after-tax contributions), (iv) the introduction of non-spouse designated beneficiaries as eligible to make rollover contributions, and (v) the treatment of distributions from a qualified plan to a non-resident alien.

In Notice 2009-68, the IRS issued two updated safe harbor 402(f) notices to address the above-noted recent changes in the law – one of which is recommended for distributions from a non-Roth account (click here to access the notice) and the other is recommended for distributions from a Roth account (click here to access the notice). Notice 2009-68 provides that plan administrators may continue to use the previously-published safe harbor notices through December 31, 2009. In the meantime, plan administrators should review the recently issued safe harbor 402(f) notices, and determine which changes are necessary to their own notices, or whether one or both the model notices should be used prospectively.

In light of a controversial statement included in the new 402(f) safe harbor notice, plan sponsors should take note of an often misunderstood rule with respect to after-tax contributions. If a participant has after-tax contributions, the participant may roll over those amounts through either a direct rollover or a 60-day rollover. However, if the participant does a direct rollover of only a part of the account and receives a distribution of the rest, each payment will include an allocable portion of the after-tax contributions.

For example, assume a participant has a $10,000 account balance with $3,000 of after-tax contributions. Assume further that the participant wants to roll over the $7,000 of taxable money to a new employer’s plan that does not accept after-tax contributions and take a distribution of the $3,000 of after-tax money. According to the statement in the new 402(f) notice, each of these two amounts would be deemed to include an allocable portion of the after-tax contributions. The IRS is aware of this issue and is considering whether changes are appropriate.

The IRS representatives indicated during the Phone Forum that the IRS expects to make Spanish translations of the model notices available.

Roth IRAs – Rollovers From Employer Plans

Notice 2009-75 describes the federal income tax consequences of rolling over an eligible rollover distribution to a Roth IRA described in Code Section 408A. Effective for distributions made after December 31, 2007, the Pension Protection Act of 2006 (the "PPA") expanded the range of distributions from qualified plans that are eligible to be directly rolled over into a Roth IRA, to include eligible rollover distributions that are not made from a designated Roth account under an eligible employer plan (a "Non-Roth Distribution"), subject to an income limitation (as described below) for tax years prior to 2010.

Income Tax Consequences. Notice 2009-75 provides that if a Non-Roth Distribution is rolled over to a Roth IRA, the amount includible in the distributee's gross income for the year of the distribution is equal to the amount that would have been includible in the distributee's gross income if the amount were not part of a qualified rollover contribution. If the amount rolled over into a Roth IRA is an eligible rollover distributions made from a designated Roth account under an eligible employer plan (a "Designated Roth Distribution"), the rollover amount is not includible in the distributee's gross income, regardless of whether the distribution is a qualified distribution from the designated Roth account (See our prior Client Alert on qualified distributions from a designated Roth account (click here to access the Client Alert)).

Rollover Limitations. Notice 2009-75 also provides that Non-Roth Distributions made before January 1, 2010, may only be rolled over to a Roth IRA if (1) the distributee's modified adjusted gross income for the year of the distribution does not exceed $100,000 and (2) if the distributee is married, that the distributee files a joint federal income tax return with his or her spouse. The income limit and joint filing requirement do not apply to a rollover of a Designated Roth Distribution to a Roth IRA, and will no longer apply to the rollover of Non-Roth Distributions to a Roth IRA made on or after January 1, 2010.

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