

## New Rules for Inherited Plan Accounts

**SITUATION:** One of our employees died in early December. His daughter is the designated beneficiary of his 401(k) plan account. She wants to roll over the account assets to an individual retirement account (IRA) so that the money can continue to grow tax deferred.

**QUESTION:** I know the Pension Protection Act of 2006 (PPA) loosened the distribution rules to allow beneficiaries other than a spouse to have inherited plan assets transferred to an IRA, starting in 2007. But, does it matter that the employee died in 2006?

**ANSWER:** No. The changes to the distribution rules are effective for distributions made from qualified plans, 403(b) tax-sheltered annuities, and governmental 457 plans after 2006, regardless of when the plan participant died.

**DISCUSSION:** Before PPA, only an employee's surviving spouse was allowed to roll over inherited benefits. Other beneficiaries generally were required to begin receiving distributions in the year following the employee's death, as specified in the plan documents. While the tax law generally allowed plans to base distributions on the non-spouse beneficiary's life expectancy, to minimize administration, many plans contained a rule requiring all benefits to be distributed to a non-spouse beneficiary within five years of the employee's death.

Often, the beneficiary was required to take the distribution in a lump sum and pay federal income taxes on the full amount immediately. Thus, not only did such beneficiaries lose the opportunity to have those assets continue to grow tax deferred for their own retirements, but many beneficiaries also lost a significant portion of the benefits to taxes.

Now, under PPA, a non-spouse beneficiary can have inherited benefits transferred to an IRA and receive payments from that IRA based on his or her life expectancy — or a shorter schedule, if desired. Non-spouse beneficiaries generally will have to begin distributions immediately. As under pre-PPA law, surviving spouses can wait until they turn age 70½ to begin taking distributions.

PPA provides specific rules for plan-to-IRA transfers of inherited benefits by non-spouse beneficiaries. For the rollover to qualify for tax deferral, the plan trustee must transfer the funds directly to the IRA trustee. The receiving IRA must be a properly titled IRA set up to receive the inherited benefits.

2 2007 Cost-of-living Adjustments

2 Faster Vesting for Employer Contributions

3 Give Your 401(k) Plan a Check-up

4 Recent Developments in Benefit Plans



## 2007 Cost-of-living Adjustments

The government has released the annual cost-of-living adjustments for various retirement plan limitations. Here are the increases:

- Defined contribution plan limit on annual additions from \$44,000 to \$45,000
- Defined benefit plan limit on annual benefits from \$175,000 to \$180,000
- Maximum annual compensation used to determine benefits or contributions from \$220,000 to \$225,000
- 401(k), SARSEP, 403(b), and 457 plan deferrals from \$15,000 to

\$15,500 (maximum catch-up contributions remain at \$5,000)

- Limits on SIMPLE deferrals from \$10,000 to \$10,500 (maximum catch-up contributions remain at \$2,500)
- Compensation defining a key employee in a top-heavy plan from \$140,000 to \$145,000
- Social Security taxable wage base from \$94,200 to \$97,500

Limits on IRA contributions/catch-up contributions stay the same at \$4,000/\$1,000. Compensation defining a highly compensated employee remains \$100,000.

## Faster Vesting for Employer Contributions

Before enactment of the Pension Protection Act of 2006, employers could use a minimum five-year cliff or seven-year graduated vesting schedule for employer nonelective contributions, such as profit sharing contributions. Not any longer. Starting with the 2007 plan year, these contributions must become nonforfeitable under a three-year cliff vesting schedule or a six-year graduated schedule, or more quickly — the same as employer matching contributions.

### Cliff Vesting

Cliff vesting is often attractive to employers that have high employee turnover during the first few years of employment. Under cliff vesting, an employee must complete a minimum number of years of service with the employer before the employee has any right to employer-made contributions. Once that service requirement is met, the contributions are 100% vested. If the employee leaves the employer before completing the service term, the employee forfeits all of the employer contributions credited to his or her account.

### Graduated Vesting

As the name implies, with graduated vesting, an employee gains “ownership” in employer contributions made on his or her behalf gradually. Under the minimum six-year graduated vesting schedule, employees with less than two years of service have no right to employer contributions. At two years, the employee earns a 20% interest in the contributions. The employee continues to earn another 20% interest with the completion of each additional year until year six, when he or she is 100% vested in the contributions. (See accompanying table.)

## Employer Nonelective Contribution Vesting Old vs. New

### Pre-PPA Minimum Vesting

#### Cliff Vesting Formula

Years of Service	Vested Percentage
5 or more	100%

#### Graduated Vesting Formula

Years of Service	Vested Percentage
Less than 3	0%
3	20%
4	40%
5	60%
6	80%
7 or more	100%

### PPA Minimum Vesting

#### Cliff Vesting Formula

Years of Service	Vested Percentage
3 or more	100%

#### Graduated Vesting Formula

Years of Service	Vested Percentage
Less than 2	0%
2	20%
3	40%
4	60%
5	80%
6	100%

## Give Your 401(k) Plan a Check-up

The Pension Protection Act of 2006 (PPA) and recent IRS and U.S. Department of Labor (DOL) guidance put a new spin on the traditional annual plan review. In addition to the usual checks, you'll want to look at new plan features you can add and consider how changes in tax and pension law will affect your plan going forward. Here are some questions that may help in your review.

**Have you evaluated your plan's investment choices lately?** To meet your fiduciary duties as a plan sponsor, you must carefully evaluate the continuing suitability of your plan's investment choices. We'd be happy to review your plan's investment lineup with you.

If your plan allows employees to direct their own account investments, note that PPA provides relief from fiduciary liability with respect to default investments for employees who do not give directions for investing their accounts. Default investments must meet DOL regulations. Under proposed regulations, these investments include life-cycle or targeted-retirement-date funds, balanced funds, and managed accounts.

You also may want to consider — or reconsider — providing investment advice to plan participants. Starting in 2007, PPA provides fiduciary relief to employers who may have been reluctant to provide detailed advice due to concerns and uncertainties about fiduciary liability for the advice. The advice must be provided under an “eligible advice arrangement.”

**Have nondiscrimination tests been performed?** If passing the actual deferral percentage (ADP) and actual contribution percentage (ACP) tests is a problem for your plan, you may want to consider a safe harbor design that will enable your plan to pass automatically. PPA introduced automatic enrollment safe harbor rules that let complying plans avoid having to conduct nondiscrimination testing. You may want to look at the new rules even if you already have a safe harbor design. The contribution cost of the automatic enrollment safe harbor would likely be less than the cost of the current safe harbor matching design. The new automatic enrollment safe harbor rules take effect with the 2008 plan year.

**What is your plan's rollover policy?** Your plan must allow a terminating employee to elect to roll over an eligible distribution directly into another employer-sponsored retirement plan or an IRA. Beneficiaries of inherited plan assets also must be allowed to transfer their benefits to an IRA. And starting in 2008, eligible employees can roll over plan assets directly to Roth IRAs. Roth rollovers will be taxable events. Your plan does *not* have to accept rollovers from other qualified retirement plans.

**Are plan loans being administered properly?** Make sure that participant loan balances don't exceed the law's maximum amounts, that all loans are on schedule to be repaid within five years (except loans to finance the purchase of a principal residence), and that any other plan-specific limits are being met. (Special rules apply to loans held by employees on active military duty.) Otherwise, the loan amounts may be treated as constructive distributions taxable to the borrowers.

**What about hardship withdrawals?** Have you incorporated recent changes in your plan? Starting with the 2006 plan year, funeral expenses of a parent, spouse, child, or dependent and certain expenses related to the repair of damages to an employee's principal residence were added to the list of reasons a plan can make a hardship distribution. Also, employees are no longer required to take a plan loan before receiving a hardship distribution if the loan would be counterproductive.

In addition, under PPA, 401(k) plan withdrawals will be allowed for hardships with respect to any person listed as a beneficiary under the plan, even if that beneficiary is not the participant's spouse or dependent. The IRS should issue regulations modifying existing hardship withdrawal rules by mid-February.

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 adviser 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.



## RECENT DEVELOPMENTS In Benefit Plans

### **Electronic Communications.**

The IRS recently released final regulations on standards for electronic transmission of plan notices, elections, and consents. Some of the notices covered include Section 402(f) eligible rollover distribution notices, qualified joint and survivor annuity notices, and Section 204(h) notices of prospective cutbacks in benefits. Under the regulations, the participant must consent to receive the communication

electronically. The timing and content of the notice must satisfy IRS rules, and the content and medium used for delivery must be reasonably designed to provide the information in a way that is no less understandable than if it had been delivered on paper.

Also, for elections: (1) employees must have effective access to the electronic medium used to send the election; (2) safeguards must be in place to prevent any person other than the employee from

making the election; (3) the employee must have a reasonable opportunity to review, confirm, modify, or rescind the election before it becomes effective; and, (4) a paper or electronic confirmation of the election must be sent to the employee within a reasonable time. If the election requires a witness, the employee's signature still must be witnessed in the physical presence of the required plan representative or notary public.

© 2006 by NPI

# NORTH CENTRAL TRUST COMPANY

Established 1913

230 Front Street North • P.O. Box 489 • La Crosse, WI 54602-0489 • 608-782-1148 • 800-658-9474 • Fax: 608-784-3880  
Riverplace • 43 Main Street S.E., Suite 214 • Minneapolis, MN 55414 • 612-339-2343 • 800-658-9474 • Fax: 612-339-2356

[www.northcentraltrust.com](http://www.northcentraltrust.com)