

XXVIII. PPA of 2006 Allows IRA Rollovers by Non-Spouse Beneficiaries.

Section 829 of the Pension Protection Act of 2006¹⁹⁴ (“PPA”) adds I.R.C. Section 402(c)(11),¹⁹⁵ allowing non-spouse beneficiaries to make direct rollovers into individual retirement plans. Important clarifications were issued by the I.R.S. in Notice 2007-7.¹⁹⁶ An additional “clarification to the clarifications” was issued by the I.R.S. in a February 13, 2007 special edition of its “Employee Plans News.” Here are the specifics of these new rollover provisions:

- ▶ Any portion of a deceased employee’s “**Eligible Retirement Plan**” (defined below in the context of I.R.C. Section 402(c)(11)),
- ▶ That passes to a non-spouse “**Designated Beneficiary**” (defined below in the context of I.R.C. Section 402(c)(11)),
- ▶ May be “rolled over” in a direct trustee-to-trustee transfer (sometimes referred to as a “direct rollover”),
- ▶ To either an I.R.C. Section 408(a) individual retirement account, or an I.R.C. Section 408(b) individual retirement annuity (collectively, an “IRA”), established for the purpose of receiving the distribution on behalf of the Designated Beneficiary.¹⁹⁷
- ▶ In the context of I.R.C. Section 402(c)(11), the term “**Eligible Retirement Plan**” refers to any plan that is:
 - (i) an individual retirement account described in I.R.C. Section 408(a);
 - (ii) an individual retirement annuity described in I.R.C. Section 408(b) (other than an endowment contract);
 - (iii) a so-called “qualified plan,” *i.e.*, an employees’ trust described in I.R.C. Section 401(a), which is exempt from tax under I.R.C. Section 501(a);
 - (iv) an annuity plan described in I.R.C. Section 403(a);
 - (v) an eligible deferred compensation plan described in I.R.C. Section 457(b), which is maintained by an eligible employer described in I.R.C. Section 457(e)(1)(A); or
 - (vi) an annuity contract described in I.R.C. Section 403(b).¹⁹⁸

¹⁹⁴ The Pension Protection Act of 2006, P.L. 109-280, 8/17/2006.

¹⁹⁵ Cross-references were also added to I.R.C. Sections 403 and 457.

¹⁹⁶ 2007-5 I.R.B. 395.

¹⁹⁷ I.R.C. § 402(c)(11).

¹⁹⁸ I.R.C. § 402(c)(8)(B).

- ▶ There is an issue as to whether a deceased employee's Roth 401(k) account can be rolled into a Roth IRA. The literal provisions of the statute do not appear to allow this, since they refer to an individual retirement account under I.R.C. Section 408. However, there is language in I.R.C. Sections 408A(a), 408A(b), and 7701(a)(37), that could be argued to support a broader interpretation of the statute that might allow such a rollover. Hopefully, further clarification on this point will be provided.
- ▶ In the context of I.R.C. Section 402(c)(11), the term "**Designated Beneficiary**" is defined by reference to I.R.C. Section 401(a)(9)(E),¹⁹⁹ which refers to "individuals," but has been amplified by regulations to include trusts, or to be more precise, to include certain individual beneficiaries of trusts if specific requirements are satisfied.²⁰⁰ Notice 2007-7 confirms that an Eligible Retirement Plan may make a direct rollover to an IRA on behalf of a trust named as the beneficiary, provided the trust's beneficiaries meet the requirements under I.R.C. Section 401(a)(9)(E) and Treas. Regs. Section 1.401(a)(9)-4, Q&A-5.²⁰¹
- ▶ There is a curious phrase in this section of Notice 2007-7, which requires that a trust must meet the requirements under I.R.C. Section 401(a)(9)(E) and Treas. Regs. Section 1.401(a)(9)-4, Q&A-5 "with respect to the IRA." However, the language of I.R.C. Section 402(c)(11) allows direct rollovers for the benefit of a designated beneficiary of the "employee," indicating that the determination is made with respect to the Eligible Retirement Plan, and not the IRA. This latter concept makes more sense. In many cases, the IRA would not and could not exist until the direct rollover occurs, and begins its existence as an "inherited" IRA.
- ▶ Your author can think of at least one situation in which this ambiguity could cause problems, as follows: A trust that otherwise meets said requirements will fail to do so with respect to a plan or IRA if certain information is not provided to the plan or IRA on or before October 31 of the calendar year following the year of death.²⁰² Thus, if the trust provides this information to the plan, but not to the IRA, a direct rollover on behalf of the trust would not be allowed under a literal reading of Notice 2007-7. Your author suggests that the safest approach is to provide the information to both the Eligible Retirement Plan and the IRA.
- ▶ As discussed in more detail below, a direct rollover is generally allowed under I.R.C. Section 402(c)(11) on or after January 1, 2007, even if it relates to a death that occurred prior to that date. However, if the October 31 deadline has already passed, a literal reading of Notice 2007-7 could preclude a direct rollover on behalf of any trust, even if the trust satisfies the requirements with respect to the Eligible

¹⁹⁹ I.R.C. § 402(c)(11)(A) flush language.

²⁰⁰ Treas. Reg. § 1.401(a)(9)-4, A-5(b).

²⁰¹ Notice 2007-7, 2007-5 IRB 395.

²⁰² Treas. Reg. § 1.401(a)(9)-4, Q&A-6(b).

Retirement Plan, since it will not be possible to submit the required information to the IRA by the October 31 deadline.

- ▶ Notwithstanding the foregoing, any part of a distribution that is required to be currently distributed by the Eligible Retirement Plan under the Minimum Distribution Rules may *not* be rolled over.²⁰³
- ▶ A direct rollover under I.R.C. Section 402(c)(11) is an eligible rollover for purposes of I.R.C. Section 402,²⁰⁴ and the resulting IRA is treated as an inherited IRA within the meaning of I.R.C. Section 408(d)(3)(C),²⁰⁵ subject to the minimum distribution rules that generally apply to inherited IRAs.²⁰⁶
- ▶ Note that once amounts are rolled into the Designated Beneficiary's "inherited IRA," the amounts are no longer in the deceased employee's Eligible Retirement Plan, and further rollovers are not possible. Of course, the inherited IRA can be moved from one financial institution to another, provided it is transferred on a direct "institution to institution" basis.
- ▶ There is no time limit under I.R.C. Section 402(c)(11) for the Designated Beneficiary of an Eligible Retirement Plan to make a direct rollover. However, as a practical matter, if a rollover is needed it is likely to best to make the rollover as soon as possible, subject to the issues discussed next.
- ▶ A "post-mortem" planning period is generally allowed under the minimum distribution regulations, postponing the final determination of the Designated Beneficiary of plan until the September 30 of the calendar year following the calendar year of death. Although one could argue that it might not be possible to make a rollover prior to the September 30 date, since the identity of the Designated Beneficiary is not certain until then, your author views this position as unnecessarily extreme. Thus, as a practical matter, your author believes (but has no authority to cite) that anyone who is a Designated Beneficiary may proceed at any time. However, in those cases in which a rollover is contemplated, and in which a disclaimer or other post-mortem planning transaction may occur, some careful thought should be devoted to the optimal ordering of these events, and the details of documenting them. Your author anticipates that in most cases, it will be best to complete the post-mortem planning first, and then have those who are the ultimate Designated Beneficiaries proceed with the rollover. Since there is often an advantage to completing the rollover in the year of death (before another minimum

²⁰³ I.R.C. § 402(c)(4)(B).

²⁰⁴ I.R.C. § 402(c)(11)(A)(i).

²⁰⁵ I.R.C. § 402(c)(11)(A)(ii).

²⁰⁶ I.R.C. § 402(c)(11)(A)(iii).

distribution for the following year comes due), it may be advisable to proceed quickly with each step of the process.

- ▶ This provision applies to distributions occurring after December 31, 2006, regardless of whether the employee's death occurred before or after said date.
- ▶ "We Were Just Kidding Department" - Part 1: The minimum required distribution rules ("MRD Rules") set the "outside limit" of what plans are allowed to do, but some plans choose to provide further limits on distributions (referred to as "plan rules"). A classic example of a plan rule is a provision that requires a non-spouse beneficiary to take his or her distribution in a lump sum. When I.R.C. Section 402(c)(11) was first enacted, there was excitement in financial circles that beneficiaries who would be denied "stretched out distributions"²⁰⁷ under the "plan rules" could now use the direct rollover to move their benefit into an IRA that would allow them a "stretch out." (Remember, if the person seeking the direct rollover does not qualify under the MRD rules as a Designated Beneficiary for whatever reason, the direct rollover is simply not an option.) Notice 2007-7 attempts to address these issues in Q&A 19 (with a further clarification provided in the February 13, 2007 special edition of the I.R.S. "Employee Plans News"), but the answers remains less than clear. The MRD Rules operate differently depending on whether the decedent died before his or her required beginning date ("RBD"). If a decedent dies on or after his or her RBD, and a direct rollover is made of decedent's Eligible Retirement Plan to an IRA, the IRA must make distributions "using the same applicable distribution period as would have been used under the plan if the direct rollover had not occurred."²⁰⁸ This suggests that the plan rules would limit the distributions from the rollover IRA. If the decedent had died prior to his or her RBD, the rule appears to provide that the IRA may use the life expectancy method (assuming the beneficiary would have qualified for that method under the MRD Rules), even if the plan rules would otherwise require the five year rule, *further provided that the direct rollover occurs prior to the end of the calendar year following the year of decedent's death.*²⁰⁹ This clarification still does not appear to provide any relief if the Eligible Retirement Plan imposes some other limitation under the plan rules, such as a lump sum distribution. If this is the correct interpretation, one can not help but wonder, why was I.R.C. Section 402(c)(11) enacted in the first place?
- ▶ "We Were Just Kidding Department" - Part 2: Although I.R.C. Section 402(c)(11) clears the way to make a direct rollover to an IRA possible for a non-spouse Designated Beneficiary, the underlying plan documents of the Eligible Retirement Plan must contain language authorizing this distribution option. Obviously, this

²⁰⁷ Terms such as "stretch out" generally refer to what is known in MRD jargon as the "life expectancy method" of calculating MRDs over a Designated Beneficiary's single life expectancy.

²⁰⁸ Notice 2007-7, 2007-5 IRB 395, Q&A 19.

²⁰⁹ *Id.*, as clarified in February 13, 2007 special edition of I.R.S. "Employee Plans News."

language was not present in plan documents existing at the time of enactment. Some plans have amended their documents, and others have not. There is no assurance that any given plan will authorize this form of distribution.

- ▶ California income tax rules will be in conformity with this new rollover provision.²¹⁰

²¹⁰ California Rev. & Tax. Code § 17501(b).

