

**RE: Notice 2007-7: Pension Protection Act Implementation Issues
Summary of Guidance Applicable to Governmental Retirement Plans**

FROM: Paul Zorn
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On January 10, 2007, the U.S. Treasury Department and the Internal Revenue Service (IRS) issued Notice 2007-7 providing implementation guidance on several provisions of the 2006 Pension Protection Act (PPA). This memorandum summarizes portions of the guidance applicable to governmental retirement plans, including 403(b), 457(b), and grandfathered 401(k) plans, related to:

- Waiver of the 10% early distribution penalty for public safety employees;
- Tax-free distributions for health insurance premiums of retired public safety officers;
- Rollovers to nonspouse beneficiaries; and,
- Hardship distributions for primary beneficiaries.

Waiver of the 10% Early Distribution Penalty for Public Safety Employees

Section 828 of the PPA waives the 10% penalty for early distributions made to “qualified public safety employees” who separate from service after attaining age 50 (instead of age 55, as was the case prior to the Act). This provision applies to distributions made after the PPA’s date of enactment (August 17, 2006). Notice 2007-7 explains:

- “Qualified public safety employee” means an employee of a State or political subdivision (e.g., city or county) whose “principle duties include services requiring specialized training” in the area of police protection, firefighting services, or emergency medical services for any area within the jurisdiction of the State or political subdivision. [Q&A-6]
- To qualify for the exemption, the qualified public safety employee must have received the distribution from a governmental defined benefit plan after separating from service with the employer maintaining the plan, and the separation from service must have occurred during or after the calendar year in which the qualified public safety employee attained age 50. Consequently, a qualified public safety employee who separates from service on June 30, 2006, and attained age 50 on December 12, 2006, would be eligible for the exception. [Q&A-7]
- The exception applies only to amounts distributed from a governmental defined benefit plan and does not apply to distributions from a defined contribution plan or an individual retirement plan. [Q&A-9]
- In reporting such distributions to the IRS, a payer is permitted to use code 2 (early distribution, exception applies) in Box 7 of Form 1099-R. Alternatively, a payer may use

code 1 (early distribution, no known exception), if the payer does not know whether the exception applies. [Q&A-10]

Tax-Free Distributions for Health Insurance Premiums of Retired Public Safety Officers

Section 845 of the PPA allows “eligible retired public safety officers” to elect to exclude from gross income certain distributions made from an “eligible government plan” to pay “qualified health insurance premiums.” Eligible government plans include governmental defined benefit and defined contribution plans described in IRC § 401(a), tax-sheltered accounts or annuities under IRC §§ 403(a) and 403(b), and governmental deferred compensation plans under IRC § 457(b). Qualified health insurance premiums include premiums for accident and health insurance or long-term care insurance contracts for the eligible retired public safety officer, his or her spouse, and dependents. The exclusion is limited to the aggregate amount of actual annual premiums paid, up to \$3,000. To be eligible, the premiums must be paid directly by the retirement plan to the insurance provider. This provision applies to distributions in taxable years beginning after December 31, 2006. Notice 2007-7 explains:

- A person is an “eligible retired public safety officer” for this purpose only if the individual “separated from service, either by reason of disability or after attainment of normal retirement age, as a public safety officer with the employer who maintains the eligible government plan from which distributions to pay qualified health insurance premiums are made.” Consequently, a public safety officer who retires before attaining normal retirement age would not be eligible, unless the retirement was due to disability. [Q&A-20]

Comment: *Public safety plans often have multiple eligibility requirements for unreduced retirement benefits (e.g., age 55 with 10 years of service or any age with 25 years of service). Under such plan provisions, a participant who began working as a public safety officer at age 25 could retire with unreduced benefits at age 50. Arguably, qualification for an unreduced retirement benefit should be sufficient to ensure qualification as an “eligible retired public safety officer.” However, the IRS has not ruled on this issue.*

- The favorable tax treatment is available “only when an eligible retired safety officer elects to have an amount subtracted from his or her distributions from an eligible government plan and such amount is used to pay qualified health insurance premiums.” An employer sponsoring the qualified retirement plan is not required to offer such an election. [Q&A-22]

Comment: *The Notice makes no statement regarding the frequency of such elections. Presumably, the election need only be made once.*

- The accident or health insurance plan receiving the payments may **not** be a self-insured plan. Rather, it must be a plan “providing insurance issued by an insurance company regulated by a State (including a managed care organization that is treated as issuing insurance.” [Q&A-23]

Comment: *Many benefit professionals who worked on this provision believe the exclusion of self-insured plans is contrary to the provision’s original intent. For a detailed analysis, see the letter by Ice Miller attorneys to representatives of the Treasury and IRS, posted at: http://www.ncpers.org/artman/uploads/IRSLtr_IceMiller.pdf*

- Benefits attributable to service other than as a public safety officer are eligible for favorable tax treatment under this provision, but only if the individual satisfies the definition of eligible retired public safety officer. [Q&A-24]

- Upon the death of the eligible retired public safety officer, the tax-exclusion would not extend to amounts subtracted from distributions for other distributees (i.e., the officer's spouse and dependents). [Q&A-25]

Rollovers to Nonspouse Beneficiaries

Section 829 of the PPA allows nonspouse beneficiaries to directly roll over an eligible rollover distribution from a "qualified retirement plan" to an "inherited" individual retirement account (or individual retirement annuity) specifically established to receive the distribution, provided the rollover is made through a trustee-to-trustee transfer. Qualified retirement plans include governmental defined benefit and defined contribution plans, as well as 403(b) annuities and governmental 457(b) plans. This provision applies to distributions made after December 31, 2006. Notice 2007-7 explains:

- A plan is **not** required to offer a direct rollover to a nonspouse beneficiary. Rollovers to nonspouse beneficiaries are **not** subject to the rollover requirements of IRC § 401(a)(31), the rollover notice requirements of § 402(f), or the mandatory 20% withholding requirements of § 3405(c). [Q&A-14, Q&A-15]

***Comment:** However non-periodic distributions that do not qualify for rollover treatment are generally subject to 10% withholding under IRC § 3405(b)(1), unless the recipient elects to forego the withholding as provided under IRC § 3405(b)(2).*

- The inherited IRA must be established in a manner that identifies it as an IRA with respect to the deceased individual and the beneficiary, for example: "Tom Smith as beneficiary of John Smith." [Q&A-13]
- A plan may make a direct rollover to an IRA on behalf of a trust, where the trust is the named beneficiary of the deceased employee, so long as the trust meets the requirements for designated beneficiaries provided in IRC § 401(a)(9)(E). [Q&A16]

In addition, the Notice provides guidance for determining the required minimum distribution amount that is not eligible for rollover to a nonspouse beneficiary. [Q&A-17 through Q&A-19]

Hardship Distributions for Primary Beneficiaries

Generally, distributions from 401(k) plans, 403(b) annuities, and 457 plans may not be made before certain specific events. For 401(k) plans and 403(b) annuities, these events include a hardship resulting from an employee's "immediate and heavy" financial need. Similarly, for 457 plans and certain nonqualified deferred compensation plans (subject to IRC § 409A), distributions can be made in the event of an "unforeseeable emergency." Qualifying events also include a hardship or unforeseeable emergency of the employee's spouse or dependents.

Section 826 of the PPA directs the Secretary of the Treasury to modify the hardship distribution rules for 401(k), 403(b), 457(b) and 409A plans to treat a "primary beneficiary under the plan" in the same manner as the participant's spouse or dependents in determining whether the participant has incurred a hardship or unforeseeable emergency. This provision is effective upon the PPA's date of enactment (August 17, 2006). Notice 2007-7 explains:

- A “primary beneficiary under the plan” is an individual who is “named as a beneficiary under the plan” and who has an “unconditional right to all or a portion of the participant’s account under the plan upon the death of the participant.” [Q&A-5]

Conclusion

This memorandum summarizes certain guidance provided by Notice 2007-7 that is applicable to governmental retirement plans, but is not intended to completely describe all applicable guidance. Plan administrators and other benefit professionals responsible for reviewing and updating plan provisions should consult the Notice directly. Additionally, qualified legal counsel should be consulted to ensure plan provisions comply with applicable laws and regulations.

The full text of Notice 2007-7 is available at: <http://www.irs.gov/pub/irs-drop/n-07-07.pdf>