

Legal Update for Governmental Plans
National Council on Teacher Retirement

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LEGAL UPDATE

I. BENEFIT CHANGES

One of the areas we see generating significant activity currently is unfortunately likely to be one of ever increasing activity in 2010. Litigation on benefit changes is already starting to wind its way into the various court systems. We know there is increasing pressure to make various benefit changes in an effort to address sustainability concerns. We believe a rigorous process is necessary to accurately assess what benefits may be changed and what categories of individuals may have their benefits changed. The answers will differ by state and by retirement plan. Ultimately, courts will decide whether many changes that are made will survive or not.

A. Legal Framework

1. The Federal Contract Clause

Article I, section 10, clause 1 of the United States Constitution states: "No State shall ... pass any ... Law impairing the Obligation of Contracts." ("Contract Clause"). This clause applies only to the States (the Due Process Clause applies to the federal government and provides similar protection). There is no specific definition in the Constitution of what constitutes a contract or whether pension obligations are covered by the Contract Clause.

2. State Constitutional Provisions

States fall into three categories with respect to state constitutional protections for pension and retirement benefits:

- a. No constitutional provision. If the State constitution does not contain a provision on pension benefits, contract rights, or vested rights, then the U.S. Constitution may provide a source of protection for contract rights.
- b. General constitutional protection of contracts or vested rights.
- c. Specific constitutional protection of pension and retirement benefits. If there is a specific provision, what employers does the protection apply to, e.g., all public employees, just the state employees, just political subdivision employees? What benefits does the protection apply to, e.g., pensions, retiree health coverage, other?

Thus, the first analysis must be what the state constitution provides, as well as any statutory protections.

3. The U.S. Trust Case

In 1977 the United States Supreme Court issued United States Trust Co. v. New Jersey, 431 U.S. 1 (1977). In this case the New Jersey legislature sought to repeal legislation implementing a limitation agreement which was designed to reassure Port Authority bondholders regarding the financial security of the bonds. The Court found that because the legislation was

seeking to relieve the state of its own obligations, deference to legislative judgment was not appropriate. Therefore, the Court assessed whether the state's action was "necessary and reasonable." The Court found the law to be neither, because alternative means were available to promote the goals of the legislation.

Any analysis of state action needs to consider the possible applicability of the Contract Clause. If a federal court was to treat governmental pensions as constituting contracts (to whatever degree), the court could follow a basic three-step analysis for determining whether legislation which impairs the contractual obligations of a governmental unit violates the Contract Clause:

a. Step One: Contractual Relationship: Does a contractual relationship exist? The Supreme Court has stated that "[i]n general, a statute is itself treated as a contract when the language and circumstances evince a legislative intent to create private rights of a contractual nature enforceable against the State." *United States Trust Co.*, 431 U.S. at 17, n.14. Additionally, "the obligations of a contract long have been regarded as including not only the express terms but also the contemporaneous state law pertaining to interpretation and enforcement." *Id.* at 19, n.17.

b. Step Two: Substantial Impairment: Does the legislation constitute a substantial impairment of a contractual relationship? **Note**: From the beginning, the Supreme Court has held that, if a state reserved the right to modify the terms of the contract, either by a provision in the contract or a general statutory scheme, the state could subsequently modify the contract without violating the Contract Clause. See, e.g., *Trustees of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518, 666 (1819) (Story, J. concurring opinion). However, later cases have required a very explicit reservation to allow modification if a third party has accrued rights under the contract—a general reservation is insufficient. If a state explicitly reserves the right to modify benefit levels, any subsequent modification may be considered an insubstantial impairment. See *Rotunda and Nowak*.

c. Step Three: Narrowly Tailored to Serve a Public Purpose: Is the law that impairs the obligation justified by a significant and legitimate public purpose? Is the method used to advance the public purpose reasonable and necessary?

(i) Police Powers v. Economic Obligations. A state cannot bargain away its police powers, which are necessary for the protection of the health and safety of its citizens. However, states will be held to their economic obligations if unrelated to a police power. See *Rotunda and Nowak*.

(ii) Reasonable. Whether a method is reasonable should be judged in light of whether the effects which the legislation is seeking to remedy "were unforeseen and unintended by the legislature" when the statute creating those obligations and rights was adopted. *United States Trust Co.*, 431 U.S. at 27.

(iii) Necessary. To be considered necessary, two conditions must be satisfied. First, no less drastic modification could have been implemented to

address the issue. Second, the state could not have achieved its stated goals without the modification. Id. at 29-30.

4. Court Interpretations of Constitutional Provisions

a. For states with no constitutional provision, a limited number of state courts have found that pensions are a gratuity to which no protection applies. Other states in this category have applied the federal Contract Clause.

b. For states where a general constitutional contract clause protection is applied to pension and retirement benefits, there is a wide variation among state courts as to when that contract clause protection vests:

- (i) Upon commencement of employment.
- (ii) Upon commencement of participation in the plan.
- (iii) After fulfilling service requirements.
- (iv) Upon eligibility for a pension.
- (v) Upon retirement.

c. Courts in states which recognize a constitutional protection of pension and/or retirement benefits have also recognized that benefits may be subject to modifications in limited circumstances. These limited circumstances include:

- (i) Where a disadvantage is offset by an advantage.
- (ii) Where a change is reasonable and necessary to preserve the pension system or its stability.
- (iii) Where a change is reasonable and necessary to maintain the integrity of the pension system.
- (iv) Where the creator of the plan has reserved the right to amend the plan.
- (v) Where there are compelling reasons that mandate and justify a unilateral change.

Thus, the second analysis must be what the applicable courts have said. If the state courts have not ruled on pension rights, look at state court decisions in other states – particularly if those other states have similar constitutions and laws. In addition to state court cases, look at federal court decisions on pension rights and contractual rights.

B. Application of Legal Framework

1. Common Themes Found in Cases

There are a few common themes (although all have their exceptions):

- a. Those individuals who are hired after a change occurs cannot claim that their rights have been impaired.
- b. On the other hand, in most states employees who are actually retired and receiving benefits are protected as to the benefit being paid (barring erroneous benefit payments, and perhaps not as to any prospective changes (e.g., COLAs) to the benefit).
- c. In most states, employees who are currently eligible for an immediate benefit have protected rights to that benefit.
- d. In contrast, in most states, when constitutional or statutory language specifies vesting requirements, individuals who have not satisfied those requirements probably have lesser or no protection.

As to the remaining population (employees who are vested but not currently eligible for an immediate benefit), there are numerous cases across the country that explore protection issues, and they reach different conclusions.

2. Questions Left Unanswered by Court Cases

What is often left unanswered by the general holdings of existing court cases is what is the exact nature of the protection afforded by constitution or statutes:

- a. If an employee started employment when benefits were X and benefits over time have been increased to 2X, is the employee who is still working vested in X or 2X?
- b. Does the protection cover solely the "core" retirement benefit, e.g., X% times years of service times final average salary?
- c. Does the protection cover any other benefits, e.g., post-retirement benefit increases, employee/employer contribution levels?
- d. Does the protection extend only to benefits accrued to the date of the impairment, or to the completion of the person's career?

C. Most Recent Cases

1. In the municipal context, the Connecticut Supreme Court upheld the lower court's interpretation of a collective bargaining agreement to provide a vested right to retirees to health insurance that survived the expiration of such agreement. Poole v. City of Waterbury, 266 Conn. 68, 98-99, 831 A.2d 211, 230 (Conn. 2003).

However, a U.S. District Court found that nearly identical language in another collective bargaining agreement did not provide active employees with vested rights to benefits. See Walker v. Waterbury, 26 EBC 2477, 2479 n. 1 (D.Conn. 2009).

2. The U.S. Court of Appeals of the 9th Circuit held that San Diego City's 3.2% reduction of pickup contributions made on behalf of San Diego City Employees' Retirement System participants imposed after an impasse in labor negotiations to address pension funding and City budgetary crises had been reached did not violate the Contract Clause of the Federal Constitution because case precedent concerning contribution levels only found the contractual right with respect to employee contribution amounts, not the share of benefit costs paid by employees. San Diego Police Officers' Ass'n v. San Diego City Employees' Ret. Sys., 568 F.3d 725 (C.A.9 2009).
3. In 2005, the Oregon Supreme Court held that:
 - a. legislation preventing employees from continuing to make contributions (picked-up or after-tax) to their regular defined benefit accounts with guaranteed interest accruals with employer matching, and prospectively requiring employee contributions to be made instead to define contribution accounts without employer matching, was not an unconstitutional impairment of contract because the statutes did not promise benefits under the Money Match formula nor promise a level of contributions to the regular account;
 - b. legislation that changed the rate of guaranteed interest accruals to regular accounts from one that was not less than the assumed earnings rate to a rate was capped at the assumed earnings rate throughout the life of the account was an unconstitutional impairment of contract because the new statute retroactively revoked past interest credits that were in excess of the assumed earnings rate;
 - c. legislation that prohibited further employee contributions to the Variable Annuity Account program was not an unconstitutional impairment of contract because the statute merely promised that contributions made to the Variable Annuity Account would be reserved for the purchase of annuities and did not contain a promise to permit continued contributions to the Account;
 - d. legislation that temporarily suspended annual cost-of-living adjustments ("COLAs") to "fixed" service retirement allowances of certain retired members, as a means of recouping amounts the Legislature had determined to be overpayments due to improper interest crediting of regular accounts at a rate of 20% in 1999 (see City of Eugene v. State Public Employees Ret. Bd.) was an unconstitutional impairment of the State's contractual obligation to grant annual COLAs based on the Consumer Price Index (in other words, the legislation impermissibly attempted a proper overpayment recovery action by improperly adjusting a protected benefit); and

- e. legislation modifying service retirement allowances with the adoption of new actuarial equivalency factors did not impair contractual obligations because the change required the Public Employees' Retirement Board ("PERB") to periodically update its actuarial factors to ensure that allowances satisfied an "actuarial equivalency" standard and the previous statute did not promise that the PERB had absolute authority to establish permanent actuarial factors.
4. The Alaska Supreme Court held in 2008 that retirees could not pick and choose advantageous statutes effective under different legislative eras – *i.e.*, a retiree claiming an advantageous provision under a former statute could not also avoid a cost provision that was repealed under the present statute. Alford v. State, 195 P.3d 118 (Alaska 2008).
 5. The Hawaii Supreme Court held that legislation that caused "actuarial investment earnings in excess of a ten percent investment yield rate" in fiscal years 1997 and 1998 to be retroactive credits against State contributions required for those years was unconstitutional under Article XVI, Section 2 of the Hawaii Constitution. Kaho'ohanohano v. State, 114 Hawai'i 302, 162 P.3d 696 (Haw. 2007). The Court reasoned that the Constitutional provision was modeled after the New York provision, which provided an implied protection of the sources of funds for pension benefits in addition to protections of accrued benefits. Kaho'ohanahano, 162 P.3d at 732 (citing Sgaglione v. Levitt, 37 N.Y.2d 507, 337 N.E.2d 592, 594 (N.Y. 1975)).
 6. The merger of a local police retirement fund into a state-wide municipal police retirement system and the subsequent alteration of benefits did not take away vested rights because they had not vested for any of the plaintiffs who were not yet eligible for retirement. Coutee v. Municipal Police Employees' Ret. Sys., 921 So.2d 1147 (La. App. 2006).
 7. Health care benefits paid to public school retirees were not "accrued financial benefits" within the meaning of the State Constitutional provision prohibiting the diminishment or impairment of accrued financial benefits of any pension plan or retirement system because they are not monetary payments which increase in relation to number of years of service the retiree has performed. Studier v. Michigan Public Schools Employees' Ret. Bd., 472 Mich. 642, 698 N.W.2d 350 (Mich. 2005).
 8. In New Mexico, several unions have brought an action to overturn 2009 changes increasing employee contributions by 2% (state patrol) and 1.5% (other) for two years.

II. **DOMESTIC PARTNERS/SAME SEX MARRIAGES**

A. Changes to State Law

In the last several years there have been a number of important developments in this area. Eleven states and the District of Columbia now recognize same-sex relationships under various names, such as domestic partnerships, civil unions, or same-sex marriages. The states are: California, Connecticut, Hawaii, Iowa, Maine, Massachusetts, New Hampshire, New Jersey, Oregon, Vermont, and Washington. The recognition provided by these states ranges from state-sanctioned civil unions and domestic partnership registries to the granting of certain spousal rights to same-sex couples. New York, DC, Rhode Island now recognize these relationships, but do not perform the ceremonies.

Several states now require domestic partner benefits to be offered to all public employees. In addition, a number of states have adopted laws which facilitate domestic partner benefits by requiring all group health insurers and/or HMOs to make domestic partner benefits available. California, Hawaii, Maine, New Jersey, and Vermont are examples of states which have adopted laws requiring insurers to provide some level of domestic partner benefits. Finally, some local ordinances require that any employers contracting with a particular city, such as San Francisco, provide domestic partner benefits to their employees. (For more information regarding state law statistics, *see* the Human Rights Campaign website: www.hrc.org or the DOMA Watch website: www.domawatch.org.)

B. Tax Issues

1. The federal Defense of Marriage Act, P.L. 104-199 ("DOMA") provides as Section 3 that:

In determining the meaning of any Act of Congress, or of any ruling, regulation or interpretation of the various administrative bureaus and agencies of the United States, the word "marriage" means only a legal union between one man and one woman as husband and wife, and the word "spouse" refers only to a person of the opposite sex who is a husband or wife.

Through DOMA, Congress has made it very clear that same-gender spouses are not to be treated as the equivalent of opposite-sex spouses for purposes of applying federal law.

2. Consequently, as to benefit plans, there is often tension between the state law and DOMA. We see these situations as raising two issues: equality of benefits provided (which is within the state's control) and equality of federal tax treatment (which is not within the state's control). We note that federal tax treatment encompasses not just the impact on the member's or same-gender spouse's tax return, but also the many federal tax rules impacting timing of distributions and flexibility of benefit forms. The areas that must be considered when any such law is passed affecting a plan include:

- a. Compliance with Plan Document.
- b. Code Section 401(a)(9) – Minimum Distribution Rules.
- c. Code Section 401(a)(31) – Rollover Rules
- d. Code Section 414(p) – Qualified Domestic Partner Relations Order.

III.
NORMAL RETIREMENT AGE

1. Summary of Law

Section 905 of the PPA amends IRC § 401(a) and § 3(2)(A) of the ERISA to permit distributions from qualified pension plans to individuals who have not separated from employment. This Section allows (but does not mandate) a qualified pension plan to provide that a distribution may be made to an employee who reaches age 62 even though the employee has not separated from service. Previously, the IRS has indicated that the prohibition on in-service distributions did not prevent benefit commencement to an employee who had reached normal retirement age (or eligibility for an unreduced benefit under the terms of the plan).

2. Effective Date

Effective for distributions made in plan years beginning after December 31, 2006. However, IRS issued Notice 2008-98, extending the effective date for governmental plans to plan years beginning on or after January 1, 2011. Per the IRS, "This will give governmental plans two additional years to comply with the requirements in the normal retirement age regulations."

3. Update

- a. Notice 2007-8.
- b. Final regulations were issued defining normal retirement age, including rules on in-service distributions. 72 FR 28604, May 22, 2007.
- c. IRS issued Notice 2007-69 requesting comments on years of service as normal retirement age. 2007-35 IRB 468, August 10, 2007.

IV.
UPDATE ON PENSION PROTECTION ACT PROVISIONS AFFECTING
GOVERNMENTAL PLAN GENERALLY

A. Amendment Deadlines

The amendment deadline for governmental plans is the last day of the plan year beginning in 2011. PPA § 1107; see Rev. Proc. 2007-44. Note that PPA amendments were on

the Cycle C Cumulative List as a separate section. However, for Cycle D, the PPA amendments were integrated into the Cycle D Cumulative List.

B. IRC § 72(t) – Penalty Free Withdrawals From Retirement Plans For Individuals Called To Active Duty For At Least 179 Days (PPA § 827)

1. Summary of Law

Section 827 of the PPA amends IRC § 72(t) to eliminate the 10% early distribution penalty with regard to "qualified reservist distributions," which are distributions to reservists who are ordered or called to active military duty for more than 179 days or an indefinite period. The distribution must be made from an IRA, or from elective deferrals under a 401(k) plan or a 403(b) program, during the active duty period (treated as beginning on the date of the order or call to duty), but a severance of employment is not required. A 401(k) plan or 403(b) program does not violate the in-service distribution restrictions by making a qualified reservist distribution.

The qualified reservist distribution may be contributed to an IRA (in one or more payments) outside the maximum contribution limits within two years after the active duty ends. The amendment pertains to individuals called to active duty after September 11, 2001, and affected taxpayers may claim a refund or credit for penalty taxes already paid if claimed before the close of the two-year period. The JCT Explanation defines a qualified reservist distribution as a distribution from:

- An IRA, or
- Elective deferrals to a 401(k) plan, 403(b) annuity or "certain similar arrangements"

IRC § 72(t), as amended by the PPA, provides that the elective deferrals must be as defined in IRC §§ 402(g)(3)(A) or (C) or IRC § 501(c)(18)(D)(iii). (IRC §§ 402(g)(3)(A) and (C) cover 401(k) plans and 403(b) plans. IRC § 501(c)(18)(D)(iii) covers trusts created before June 25, 1959 funded only by employee contributions that meet certain requirements.)

2. Effective Date

A qualified reservist distribution applies to an individual ordered or called to active duty after September 11, 2001, and before December 31, 2007. The waiver of penalty and distribution limitations is effective for distributions after September 11, 2001. The two-year period runs to the later of the actual two year period or August 17, 2008.

3. Update

- a. News Release IR 2006-52
- b. HEART made this provision permanent.

C. **IRC § 401(a)(9) – Clarification Of Minimum Distribution Rules For Governmental Plans (PPA § 823)**

1. **Summary of Law**

Section 823 of the PPA requires the Secretary of the Treasury to issue regulations to provide relief for governmental plans with respect to the minimum distribution rules of IRC § 401(a)(9). The regulations must allow governmental plans to comply with "a reasonable good faith interpretation of the statutory requirements."

2. **Effective Date**

The provision is effective August 17, 2006. However, the JCT Explanation states the Congressional intent that the regulations apply for periods before August 17, 2006.

3. **Update**

a. The IRS has issued final regulations – 1.401(a)(9)-1, Q&A-2 : "Notwithstanding anything to the contrary..., a governmental plan (within the meaning of section 414(d)), or an eligible governmental plan described in § 1.457-2(f), is treated as having complied with section 401(a)(9) for all years to which section 401(a)(9) applies to the plan if the plan complies with a reasonable and good faith interpretation of section 401(a)(9)." See also Treas. Reg. § 1.403(b)-6(e)(8).

b. IRS Notice 2009-82 for Guidance on 2009 Required Minimum Distributions for defined contribution plans, 403(b) plans and 457(b) plans.

D. **IRC § 402 – Rollovers Of After-Tax Amounts (PPA § 822)**

1. **Summary of Law**

Section 822 of the PPA amends IRC § 402(c)(2)(A) to permit qualified plans (whether defined benefit or defined contribution) and section 403(b) plans to accept after-tax direct rollover amounts from a qualified retirement plan, so long as the plan separately accounts for such after-tax amounts.

2. **Effective Date**

Effective for taxable years beginning after December 31, 2006.

3. **Update**

a. Final 403(b) Regulations; see FAB 2007-2

b. Note: WRERA provides that a rollover from a Roth designated account in a tax-qualified plan, or 403(b) plan, to a Roth IRA is not subject to the gross income inclusion and adjusted gross income conditions. WRERA § 108(d).

E. IRC § 402(c) – Rollovers By Nonspouse Beneficiaries Of Certain Retirement Plan Distributions (PPA § 829)

1. Summary of Law

Section 829 of the PPA amends IRC §§ 402(c), 403(b), and 457(b) to permit these plans to provide an additional option for nonspouse beneficiaries who are eligible to receive distributions from qualified retirement plans, section 403(b) plans and section 457(b) governmental plans. To be eligible to make such a direct transfer, (1) the nonspouse beneficiary must be a designated beneficiary of the participant as of date of the participant's death as defined by IRC § 401(a)(9)(E), and (2) the distribution must qualify as an eligible rollover distribution. An individual (or an individual who is the designated beneficiary of a trust) may be designated as a participant's beneficiary either by the terms of the plan or, if the plan so provides, by an affirmative election by the participant.

Nonspouse beneficiaries must utilize a direct rollover, *i.e.*, a direct trust-to-trust transfer mechanism. The amounts transferred to the individual retirement account or annuity by a nonspouse beneficiary will be treated as an "inherited" individual retirement account or annuity. This means, for example, that the nonspouse beneficiary will not be treated as the owner of the rolled over assets and those assets, once transferred to the inherited IRA, may not be rolled over further and the nonspouse beneficiary cannot make any additional contributions to the inherited IRA.

2. Effective Date

Effective for distributions after December 31, 2006.

3. Update

a. See Notice 2007-7. See also Employee Plans News Special Edition, February 13, 2007.

b. Notice 2008-30 provides that nonspouse beneficiaries may utilize rollovers to Roth IRAs.

c. Amendments to Safe Harbor for Distributions from Terminated Plans for Missing Nonspouse Beneficiaries

d. WRERA requires plans to provide for direct rollovers by a nonspouse beneficiary effective with the 2010 plan year.

e. IRS issued new tax notice last month – See IRS Notice 2009-68.

F. IRC § 408A – Direct Rollovers From Retirement Plans To Roth IRAs (PPA § 824)

1. Summary of Law

Section 824 of the PPA amends IRC § 408A(d) and adds IRC § 408A(e) to allow members in eligible retirement plans (including qualified defined benefit and defined contribution plans, section 403(b) plans, and section 457(b) governmental plans) to make direct rollovers of eligible rollover distributions from such plans to Roth IRAs, subject to the rules that apply to rollovers from a traditional IRA to a Roth IRA. These rules provide that a rollover from a qualified retirement plan into a Roth IRA is includible in gross income (except to the extent it represents a return of after-tax contributions). Additionally, the 10% premature distribution tax does not apply.

Such rollovers are subject to the limitations on rollovers to Roth IRAs based on modified adjusted gross income under IRC § 408A(c)(3)(B). This means that an individual with modified adjusted gross income of \$100,000 or more could not elect this direct rollover option. See IRC § 408A(c)(3)(B) (tax years beginning on or before December 31, 2009). See, also, changes to IRC § 408A contained in Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222) for rollovers in 2010.

2. Effective Date

Effective for distributions made after December 31, 2007.

3. Update

a. Notice 2008-30 clarifies that employer plan must provide for rollovers to Roth IRAs. However, payor is not responsible for assuring distributee is eligible to make a rollover to Roth IRA. 2008-12 IRB 638, March 5, 2008.

b. 10% withholding and 20% withholding are not applicable, but payor and payee may enter into voluntary withholding agreements.

c. Premature distribution tax is not assessed on amount rolled over to Roth IRA.

d. Rollover amounts are reported on a 1099-R, with the taxable amounts reported.

e. Voluntary withholding amounts are treated as if distributed and are reported on a separate 1099-R.

G. IRC § 415(b)(2)(E) – Increasing Participation Through Automatic Contribution Arrangements (PPA § 303)

1. Summary of Law

In order to calculate lump sums (and other benefit forms) to which IRC § 417(e) (qualified joint and survivor annuities) applies, interest rate assumptions for IRC § 415(b) limitation purposes were changed by the PPA from using just the interest rate on 30-year Treasury securities to the rate that provides a benefit of not more than 105 percent of the benefit that would be provided if the interest rate on 30-year Treasury securities were the interest rate assumption. The result is that the greatest of this rate, 5.5%, or the interest rate specified in the plan must be used. In the case of a plan under which lump-sum benefits are determined solely as required under the minimum value rules (rather than using an interest rate that results in larger lump-sum benefits), the interest rate specified in the plan is the interest rate applicable under the minimum value rules.

2. Effective Date

Effective for distributions made in years beginning after December 31, 2005.

3. Update

- a. Notice 2007-7, Section II
- b. Final 415 Regulations
- c. See Notice 2008-85
- d. WRERA changed effective date of provision.

H. PPA § 1102 – Notice And Consent Period Regarding Distributions

1. Summary of Law

Section 1102 amends ERISA to provide that the notice and consent period regarding distributions is to be extended so that the applicable distribution notice must be given no less than 30 days and no more than 180 days before the date distribution commences. Current law provides for 90 days rather than 180 days. As the JCT Explanation provides this notice must contain direct rollover information and rules regarding taxation. The Secretary of the Treasury is ordered to modify applicable regulations to implement this change.

2. Effective Date

This PPA provision takes effect January 1, 2007.

3. Update

- a. See Notice 2007-7, Section VIII.

I. IRC § 414(w) – Increasing Participation Through Automatic Contribution Arrangements (PPA § 902)

1. Summary of Law

The PPA adds IRC § 414(w), establishing rules for "eligible automatic contribution arrangements" ("EACAs"). These are generally defined as arrangements where a participant is treated as having elected to have an employer make a plan contribution on behalf of the participant as a uniform percentage of the participant's compensation until the participant specifically elects not to have such contribution made (or elects a different contribution percentage rate). An eligible automatic arrangement is also required to provide that, in the absence of investment direction by the participant, automatic contributions must be invested in accordance with ERISA § 404(c)(5). Under IRC § 414(w), an employer may allow in-service "permissive withdrawals" from such an arrangement, in which case employees can avoid the early distribution penalty if the withdrawal is made within 90 days of the first automatic contribution and the plan meets new notice requirements. Generally, the notice must be provided annually to employees in the automatic contribution arrangement, explaining the terms of the arrangement and the employee's rights under the arrangement. Qualified section 401(a) plans, section 403(b) plans, and section 457(b) plans are covered by this new provision.

2. Effective Date

Effective for plan years beginning after December 31, 2007.

3. Update

a. IRS issued proposed and final regulations. The final regulations relating to EACAs apply for plan years beginning on or after January 1, 2010. Prior to the 2010 plan year, the plan must operate in accordance with good faith interpretation of the EACA requirements and may rely on either the proposed regulations or the final regulations.

b. See Rev. Rul. 2009-30.

J. IRC § 457, IRC § 403(b), & IRC § 401(k) – Modification Of Rules Governing Hardships And Unforeseen Financial Emergencies (PPA § 826)

1. Summary of Law

Section 826 of the PPA directs the Secretary of the Treasury to issue regulations within six months (*i.e.*, by February 17, 2007) to provide greater flexibility for purposes of hardship or unforeseeable financial emergency distributions from section 401(k), section 403(b), and section 457(b) plans, as well as nonqualified deferred compensation plans under IRC § 409A. Under current regulations, a hardship or unforeseeable financial emergency includes a hardship or unforeseeable financial emergency of a participant's spouse or dependent. The Treasury is directed to modify the hardship regulations to permit a hardship or unforeseeable financial emergency distribution with respect to any beneficiary of a participant designated under the plan who experiences a hardship or unforeseen financial emergency.

2. Effective Date

Effective August 17, 2006.

3. Update

- a. Notice 2007-7, Section III; See Announcement 2007-59.
- b. Final 403(b) Regulations 1.403(b)-6; See Field Assistance Bulletin 2007-2.

Circular 230 Disclosure

Except to the extent that this advice concerns the qualification of any qualified plan, to ensure compliance with recently-enacted U.S. Treasury Department Regulations, we are now required to advise you that, unless otherwise expressly indicated, any federal tax advice contained in this communication, including any attachments, is not intended or written by us to be used, and cannot be used, by anyone for the purpose of avoiding federal tax penalties that may be imposed by the federal government or for promoting, marketing, or recommending to another party any tax-related matters addressed herein.

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