



rollovers to iras now possible for plan beneficiaries

MSK Client Alert

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The government agencies are continuing to issue guidance with respect to provisions of the Pension Protection Act enacted this past summer. IRS Notice 2007-7 includes guidance on the new rules allowing beneficiaries, other than surviving spouses, to make rollovers of plan distributions from qualified plans to IRAs. These rules became effective January 1, 2007.

Background

Under prior law, if a participant died with a significant account balance in a qualified retirement plan and the participant's beneficiary was someone other than a surviving spouse, the beneficiary frequently could not take advantage of the minimum distribution rules that in many cases can allow the stretch-out of plan distributions over a long period of time. For example, if a participant died with a large balance in a 401(k) plan under which the only form of distribution was a lump sum and the participant designated a beneficiary other than a spouse, the beneficiary would be required to receive the distribution all at once, could not make a rollover, and would be taxable on the entire distribution at the time of receipt. By contrast, a surviving spouse can rollover the account balance to an IRA in the surviving spouse's name and then take minimum distributions over the spouse's life expectancy starting when the surviving spouse attains age 70-1/2.

The New Law

The Pension Protection Act changed this situation by allowing non-spouse beneficiaries to make rollovers to Individual Retirement Accounts provided the transfer of funds was made by direct trustee-to-trustee action. Therefore, if the distribution is paid to the beneficiary (rather than directly transferred to the IRA trustee), the beneficiary loses the right to make the rollover once he receives the funds.

attorneys

Robert J. Lowe

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The rollover rules for non-spouse beneficiaries are not as favorable, however, as the rules applicable to surviving spouses. The rollover by the non-spouse beneficiary does not extend the period for minimum distributions beyond the period already available to a beneficiary under the terms of existing law. Unlike a surviving spouse, the non-spouse beneficiary cannot wait until he or she attains age 70-1/2 to start taking minimum distributions. The IRA receiving the rollover from the non-spouse beneficiary must be established for the exclusive purpose of accepting the rollover. Therefore, the beneficiary cannot use a pre-existing IRA, for example, from the beneficiary's own deductible or rollover contributions, as could a surviving spouse. The resulting IRA is then treated as an inherited IRA so that the effect is the same as if the participant had made the rollover to an IRA prior to death and designated the beneficiary as beneficiary of that IRA.

The IRS has just issued Notice 2007-7 which clarifies a number of issues with respect to these new rollover rules:

- The IRA must be established in a manner so that the IRA is identified with respect to both the decedent and the beneficiary, for example: "Tom Smith as beneficiary of John Smith."
- A qualified plan is not required to offer this distribution option. This suggests that plans will have to be amended to provide this option, although the amendment can be retroactive. Under the general rules in the Pension Protection Act for plan amendments, amendments required by the Act can be made as late as 2009 retroactive to the applicable effective date. In the case of a terminated defined contribution plan, the plan will be deemed to offer this option even without amendment.
- If the beneficiary does not elect a rollover, the beneficiary is not subject to the mandatory 20 percent withholding rules applicable to other eligible rollover distributions.
- Minimum distributions may be taken based on the beneficiary's life expectancy starting in the year following the death of the decedent. Although, distributions may also be taken by the end of the fifth year following the death of the decedent if the decedent dies before his required beginning date (April 1 of the year following attainment of age 70-1/2), in most cases the greater tax savings can be obtained by making payments over the life expectancy of the beneficiary. The IRA documents should be reviewed carefully to make sure this option will be available.
- If the decedent dies after his required beginning date, but has not taken the minimum distribution due for the year of death, this amount is not eligible for rollover and must be distributed to the beneficiary prior to the end of the year in which the death occurs. For this reason, it is usually recommended to take the minimum distribution first and then make the rollover. Also, if there are minimum distributions that were not made for prior years, these amounts are not eligible for rollover.
- If a trust is named as beneficiary and the trust satisfies the requirements under the minimum distribution rules so that the trust beneficiaries are treated as the plan beneficiaries for minimum distribution purposes, then the IRA can be opened in the name of the trust as beneficiary of the decedent. Under these circumstances, the IRA documents should be reviewed to assure that only the trustee of the trust has the right to withdraw funds from the IRA.



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Although these new rules will apply only in a limited number of cases, they provide an excellent planning opportunity when a decedent dies with significant assets in a qualified retirement plan.

For more information, please contact Robert J. Lowe at rlo@msk.com or at (310) 312-3180. Robert is a partner at Mitchell Silberberg & Knupp LLP in the employee benefits and executive compensation practice area.