Bearmoor, LLC
Asset Management and Fiduciary Consultants

Regulatory Update
Winter 2007

Introductory Comment: As you well know, Regulation R has received a fair amount of coverage over the past few months – and rightfully so. So, in addition to the information supplied in various Regulation R articles, this issue of the Regulatory Update identifies and outlines other areas of regulatory concern of which you should also be aware

IRS - Miscellaneous Pension Protection Act Changes; Notice 2007-7

Background
On January 10, 2007 the Treasury Department and the IRS issued a notice providing extensive guidance on several Pension Protection Act rules relating to distributions from tax-qualified retirement plans. The guidance addresses many questions on PPA provisions, including:

- interest rate assumptions for lump sum distributions
- hardship distributions from a 401(k) and similar plans
- early distributions from qualified plans to terminated public safety employees
- rollovers from qualified plans to IRAs for non-spouse beneficiaries
- distributions to pay for health insurance for retired public safety officers
- earlier vesting of certain employer contributions
- new rules for the notice and consent period for distributions

The notice also clarifies several issues concerning the provision permitting IRA owners age 70 ½ or older to directly transfer tax-free, up to $100,000 per year to an eligible charity. For example, a check from an IRA made payable to an eligible charity but delivered by the IRA holder still qualifies for tax-free treatment. IRAs held on behalf of beneficiaries, as well as IRAs held by the original owners, are eligible to use this provision. Additionally, the $100,000 annual limit applies separately for each spouse of a married couple. If both spouses have IRAs and are at least age 70 ½, the couple can transfer a combined total of $200,000.

This notice provides guidance in the form of questions and answers with respect to certain provisions of the Pension Protection Act of 2006, P.L. 109-280 ("PPA '06"), that are effective in 2007 or earlier. The sections of PPA '06 addressed in this notice, which are primarily related to distributions, are § 303 (relating to interest rate assumptions for lump sum distributions), § 826 (relating to hardship distributions), § 828 (relating to early distributions to public safety employees), § 829 (relating to rollovers for non-spouse beneficiaries), § 845 (relating to distributions to pay for accident or health insurance for public safety officers), § 904 (relating to vesting of non-elective contributions), § 1102 (relating to the notice and consent period for distributions), and § 1201 (relating to distributions from IRAs to charitable organizations).

Information – Section 303 of PPA '06

Section 415(b) of the Code provides limitations on annual benefits under a defined benefit plan. Under § 415(b)(2)(B), if a benefit is payable in a form other than a straight life annuity, the benefit is adjusted to an actuarially equivalent straight life annuity for purposes of determining whether the limitations of § 415(b) have been satisfied. Section 415(b)(2)(E) provides limitations on the actuarial assumptions that can be used in making the adjustment under § 415(b)(2)(B). Prior to the enactment of PPA '06, for purposes of adjusting a benefit payable in a form that is subject to the minimum present value requirements of § 417(e)(3), § 415(b)(2)(E)(ii) provided that the interest rate assumption must not be less than the greater of the applicable interest rate as defined in § 417(e)(3) or the rate specified in the plan. However, § 101(b)(4) of the Pension Funding Equity Act of 2004, P.L. 108-218, amended § 415(b)(2)(E)(ii) to provide that, for plan years beginning in 2004 and 2005, 5.5% must be used in lieu of the applicable interest rate (as defined in § 417(e)(3)) for purposes of adjusting the benefit.

Section 303(a) of PPA '06 amended § 415(b)(2)(E)(ii) to provide that the interest rate assumption for purposes of adjusting a benefit payable in a form that is subject to the minimum present value requirements of § 417(e)(3) must not be less than the greatest of (i) 5.5%, (ii) the rate that provides a benefit of not more than 105% of the benefit that would be provided if the applicable interest rate (as defined in § 417(e)(3)) were the interest rate assumption, or (iii) the rate specified under the plan.

Q-1. What is the effective date of the changes made to § 415 of the Code by § 303(a) of PPA '06?
A-1. The changes to § 415 of the Code made by § 303(a) of PPA '06 apply to distributions made in plan years beginning after December 31, 2005. However, the changes do not apply to a plan with a termination date that is on or before August 17, 2006, the date of enactment of PPA '06.

Q-2. May a plan be amended retroactively to comply with the requirements of § 303(a) of PPA '06 without violating the anti-cutback rules provided in § 411(d)(6) of the Code?
A-2. Yes. Under § 1107 of PPA '06, a plan does not violate the anti-cutback rules of § 411(d)(6) of the Code if it is amended retroactively to comply with § 303(a) of PPA '06, provided the amendment is adopted on or before the last day of the first plan year beginning on or after January 1, 2009 (2011 in the case of a governmental plan), and the plan is operated as if such amendment were in effect as of the first date the amendment is effective.

Q-3. If a plan made a distribution in a plan year beginning in 2006 that satisfied the limitations of § 415(b) prior to the enactment of PPA '06 but which is in excess of the limitations of § 415(b) taking into account the amendments to § 415 made by § 303(a) of PPA '06 (a "§ 303 excess distribution"), does the distribution violate the requirements of § 415(b)?
A-3. Yes. However, three methods are available for correcting a § 303 excess distribution. First, Q&A-4 of this notice sets forth a special correction method that is available for a § 303 excess distribution made prior to September 1, 2006, provided that the correction is completed by March 15, 2007. Second, if correction is completed by December 31, 2007 (even if the § 303 excess distribution occurs after September 1, 2006), a plan may correct a § 303 excess distribution by using the correction method for a § 415(b) excess distribution described in the Employee Plans Compliance Resolution System ("EPCRS") (see section 2.04(1) in Appendix B in Rev. Proc. 2006-27, 2006-22 IRB 945) even if the plan does not meet the requirements specified in Rev. Proc. 2006- 27, including the special requirements for self correction under Part IV of Rev. Proc. 2006-27. Finally, a plan that meets the requirements of Rev. Proc. 2006-27 may

correct § 303 excess distributions by using the correction method for § 415(b) excess distributions under EPCRS even after December 31, 2007. A plan that is amended retroactively to comply with § 303(a) of PPA '06 will not fail to satisfy the requirement in § 1107(b)(2)(A) of PPA '06 (that the plan be operated in accordance with the terms of the amendment) merely because it made a § 303 excess distribution, provided the § 303 excess distribution is corrected using one of these three correction methods.

Q-4. What special correction method is available to correct a § 303 excess distribution made prior to September 1, 2006?
A-4. A special correction method is available for a § 303 excess distribution made prior to September 1, 2006, provided the correction is completed by March 15, 2007. Under the special correction method, a plan may use the EPCRS correction method for a § 415(b) excess distribution (as described in section 2.04(1) in Appendix B in Rev. Proc. 2006-27, even if the plan does not otherwise meet the requirements of Rev. Proc. 2006-27, including the special requirements for self correction) with the following modifications. The excess amount (i.e., the amount by which the distribution actually made exceeds the distribution permitted using the interest assumption specified in § 415(b) as amended by PPA '06) is not required to be returned to the plan (as otherwise required under the EPCRS correction method). Instead, a plan must issue two Forms 1099-R (Distributions From Pensions, Annuities, Retirement or Profit- Sharing Plans, IRAs, Insurance Contracts, etc.) to a participant who has received a § 303 excess distribution. The first Form 1099-R should include only the amount that would have been distributed had the benefit payable been adjusted using the interest assumptions specified in § 415(b) as amended by PPA '06. The second Form 1099-R should include only the excess amount that was distributed, and should include code "E" in box 7 to identify the amount as an excess distribution. As provided in the EPCRS correction, this excess amount is not an eligible rollover distribution, and therefore must be included in gross income in the year distributed from the plan.

Information – Section 826 of PPA '06
An employee's elective contributions under a cash or deferred arrangement can only be distributed upon the occurrence of certain events, one of which is the employee's hardship. A distribution is made on account of hardship only if the distribution both is made on account of an immediate and heavy financial need of the employee and is necessary to satisfy the financial need. A distribution made for any of the expenses listed in Regulation § 1.401(k)-1(d)(3)(iii)(B) is deemed to be on account of an immediate and heavy financial need of the employee. Several of these listed expenses can be expenses of the employee's spouse or dependents.

Section 826 of PPA '06 directs the Secretary of the Treasury to modify the rules relating to distributions from § 401(k), § 403(b), § 409A, and § 457(b) plans on account of a participant's hardship or unforeseeable financial emergency to permit such plans to treat a participant's beneficiary under the plan the same as the participant's spouse or dependent in determining whether the participant has incurred a hardship or unforeseeable financial emergency.

Q-5. What changes are being made pursuant to § 826 of PPA '06 in the rules relating to hardship distributions from § 401(k) plans and § 403(b) plans and relating to distributions on account of an unforeseeable financial emergency from a plan described in § 457(b) or § 409A?
A-5. (a) Hardship distributions from § 401(k) plans and § 403(b) plans. A § 401(k) plan that permits hardship distributions of elective contributions to a participant only for expenses

described in § 1.401(k)-1(d)(3)(iii)(B) may, beginning August 17, 2006, permit distributions for expenses described in § 1.401(k)-1(d)(3)(iii)(B)(1), (3), or (5) (relating to medical, tuition, and funeral expenses, respectively) for a primary beneficiary under the plan. For this purpose, a "primary beneficiary under the plan" is an individual who is named as a beneficiary under the plan and has an unconditional right to all or a portion of the participant's account balance under the plan upon the death of the participant. A plan that adopts these expanded hardship provisions must still satisfy all the other requirements applicable to hardship distributions, such as the requirement that the distribution be necessary to satisfy the financial need. These rules also apply to § 403(b) plans.

(b) Distributions on account of an unforeseeable financial emergency from a plan described in § 457(b) or § 409A. In applying § 457(d)(1)(A)(iii), § 1.457-6(c)(2)(i), § 409A(a)(2)(A)(vi), and Proposed Regulation § 1.409A-3(g)(3)(i), a plan described in § 457(b) or § 409A may treat a participant's beneficiary under the plan the same as the participant's spouse or dependent in determining whether the participant has incurred an unforeseeable financial emergency. This will be reflected in the upcoming final regulations under § 409A.

Information – Section 828 of PPA '06

Section 72(t)(1) of the Code provides for a 10% additional tax on an early distribution from a qualified retirement plan (as defined in § 4974(c)), unless the early distribution qualifies for one of the exceptions listed in § 72(t)(2). For example, § 72(t)(2)(A)(v) provides an exception to the 10% additional tax for distributions made to an employee who separates from service after attainment of age 55. Under § 72(t)(3)(A), § 72(t)(2)(A)(v) does not apply to individual retirement plans. Section 828 of PPA '06 amended § 72 of the Code by adding § 72(t)(10), which provides that in the case of a distribution to a qualified public safety employee from a governmental defined benefit plan, § 72(t)(2)(A)(v) is applied by substituting age 50 for age 55. Thus, the 10% additional tax on early distributions under § 72(t)(1) does not apply to a distribution from a governmental defined benefit plan made to a qualified public safety employee who separates from service after attainment of age 50. This exception to the 10% additional tax applies to distributions made after August 17, 2006.

Q-6. Who is a qualified public safety employee?
A-6. For purposes of § 72(t)(10), the term "qualified public safety employee" means an employee of a State or of a political subdivision of a State (such as a county or city) whose principal 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 the political subdivision of the State.

Q-7 . How does a qualified public safety employee qualify for the exception to the 10% additional tax under § 72(t)(10)?
A-7. In order to qualify for the exception to the 10% additional tax under § 72(t)(10), a qualified public safety employee (i) must have received the distribution from a governmental defined benefit plan after separating from service with the employer maintaining the plan and (ii) the separation from service must have occurred during or after the calendar year in which the qualified public safety employee attained age 50. For example, a qualified public safety employee who separated from service on June 30, 2006, and attained age 50 on December 12, 2006, is eligible for the exception under § 72(t)(10) with respect to distributions made after August 17, 2006.

Q-8. What are the consequences if, before August 18, 2006, a qualified public safety employee began receiving substantially equal periodic payments that qualify for the exception to the 10% additional tax described in § 72(t)(2)(A)(iv) and then modified the periodic payments after August 17, 2006?
A-8. If the payments satisfy the requirements in Q&A-7 of this notice, payments received by the qualified public safety employee after August 17, 2006, would qualify for the exception to the 10% additional tax under § 72(t)(10). However, if the modification would result in the imposition of the recapture tax under the rules of § 72(t)(4), then the recapture tax applies to the payments made before August 18, 2006.

Q-9. Does the exception to the 10% additional tax under § 72(t)(10) apply if the qualified public safety employee rolls over distributions from a governmental defined benefit plan into an IRA or a defined contribution plan and subsequently takes an early distribution from the IRA or defined contribution plan?
A-9. No. The exception to the 10% additional tax under § 72(t)(10) 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-10. How does a payer report distributions that qualify for the exception to the 10% additional tax under § 72(t)(10) on Form 1099-R?
A-10. A payer is permitted to use distribution code 2 (early distribution, exception applies) in box 7 of Form 1099-R. However, a payer is also permitted to use distribution code 1 (early distribution, no known exception) in box 7 of Form 1099-R, if the payer does not know whether the exception under § 72(t)(10) applies. For further information on reporting, see Instructions for Forms 1099-R and 5498.

Information – Section 829 of PPA '06

Under § 402(c)(11) of the Code, which was added by § 829 of PPA '06, if a direct trustee-to-trustee transfer of any portion of a distribution from an eligible retirement plan is made to an individual retirement plan described in § 408(a) or (b) (an "IRA") that is established for the purpose of receiving the distribution on behalf of a designated beneficiary who is a non-spouse beneficiary, the transfer is treated as a direct rollover of an eligible rollover distribution for purposes of § 402(c). The IRA of the non-spouse beneficiary is treated as an inherited IRA within the meaning of § 408(d)(3)(C). Section 402(c)(11) applies to distributions made after December 31, 2006.

Q-11. Can a qualified plan described in § 401(a) offer a direct rollover of a distribution to a non-spouse beneficiary?
A-11. Yes. Under § 402(c)(11), a qualified plan described in § 401(a) can offer a direct rollover of a distribution to a non-spouse beneficiary who is a designated beneficiary within the meaning of § 401(a)(9)(E), provided that the distributed amount satisfies all the requirements to be an eligible rollover distribution other than the requirement that the distribution be made to the participant or the participant's spouse. (See § 1.401(a)(9)-4 for rules regarding designated beneficiaries.) The direct rollover must be made to an IRA established on behalf of the designated beneficiary that will be treated as an inherited IRA pursuant to the provisions of § 402(c)(11). If a non-spouse beneficiary elects a direct rollover, the amount directly rolled over is not includible

in gross income in the year of the distribution. See § 1.401(a)(31)-1, Q&A-3 and-4, for procedures for making a direct rollover.

Q-12. Can other types of plans offer a direct rollover of a distribution to a non-spouse beneficiary?
A-12. Yes. Section 402(c)(11) also applies to annuity plans described in § 403(a) or (b) and to eligible governmental plans under § 457(b).

Q-13. How must the IRA be established and titled?
A-13. The IRA must be established in a manner that identifies it as an IRA with respect to a deceased individual and also identifies the deceased individual and the beneficiary, for example, "Tom Smith as beneficiary of John Smith."

Q-14. Is a plan required to offer a direct rollover of a distribution to a non-spouse beneficiary pursuant to § 402(c)(11)?
A-14. No. A plan is not required to offer a direct rollover of a distribution to a non-spouse beneficiary. If a plan does offer direct rollovers to non-spouse beneficiaries of some, but not all, participants, such rollovers must be offered on a nondiscriminatory basis because the opportunity to make a direct rollover is a benefit, right, or feature that is subject to § 401(a)(4). In the case of distributions from a terminated defined contribution plan pursuant to 29 C.F.R. § 2550.404a-3(d)(1)(ii), the plan will be considered to offer direct rollovers pursuant to § 402(c)(11) with respect to such distributions without regard to plan terms.

Q-15. For what purposes is the direct rollover of a distribution by a non-spouse beneficiary treated as a rollover of an eligible rollover distribution?
A-15. Section 402(c)(11) provides that a direct rollover of a distribution by a non-spouse beneficiary is a rollover of an eligible rollover distribution only for purposes of § 402(c). Accordingly, the distribution is not subject to the direct rollover requirements of § 401(a)(31), the notice requirements of § 402(f), or the mandatory withholding requirements of § 3405(c). If an amount distributed from a plan is received by a non-spouse beneficiary, the distribution is not eligible for rollover.

Q-16. If the named beneficiary of a decedent is a trust, is a plan permitted to make a direct rollover to an IRA established with the trust as beneficiary?
A-16. Yes. A plan may make a direct rollover to an IRA on behalf of a trust where the trust is the named beneficiary of a decedent, provided the beneficiaries of the trust meet the requirements to be designated beneficiaries within the meaning of § 401(a)(9)(E). The IRA must be established in accordance with the rules in Q&A-13 of this notice, with the trust identified as the beneficiary. In such a case, the beneficiaries of the trust are treated as having been designated as beneficiaries of the decedent for purposes of determining the distribution period under § 401(a)(9), if the trust meets the requirements set forth in § 1.401(a)(9)-4, Q&A-5, with respect to the IRA.

Q-17. How is the required minimum distribution (an amount not eligible for rollover) determined with respect to a non-spouse beneficiary if the employee dies before his or her required beginning date within the meaning of § 401(a)(9)(C)?
A-17. (a) General rule. If the employee dies before his or her required beginning date, the required minimum distributions for purposes of determining the amount eligible for rollover with respect to a non-spouse beneficiary are determined under either the 5-year rule described in §

401(a)(9)(B)(ii) or the life expectancy rule described in § 401(a)(9)(B)(iii). See Q&A-4 of § 1.401(a)(9)-3 to determine which rule applies to a particular designated beneficiary. Under either rule, no amount is a required minimum distribution for the year in which the employee dies. The rule in Q&A-7(b) of § 1.402(c)-2 (relating to distributions before an employee has attained age 70½) does not apply to non-spouse beneficiaries.
(b) Five-year rule. Under the 5-year rule described in § 401(a)(9)(B)(ii), no amount is required to be distributed until the fifth calendar year following the year of the employee's death. In that year, the entire amount to which the beneficiary is entitled under the plan must be distributed. Thus, if the 5-year rule applies with respect to a non-spouse beneficiary who is a designated beneficiary within the meaning of § 401(a)(9)(E), for the first 4 years after the year the employee dies, no amount payable to the beneficiary is ineligible for direct rollover as a required minimum distribution. Accordingly, the beneficiary is permitted to directly roll over the beneficiary's entire benefit until the end of the fourth year (but, as described in Q&A-19 of this notice, the 5- year rule must also apply to the IRA to which the rollover contribution is made). On or after January 1 of the fifth year following the year in which the employee died, no amount payable to the beneficiary is eligible for rollover.
(c) Life expectancy rule. (1) General rule. If the life expectancy rule described in § 401(a)(9)(B)(iii) applies, in the year following the year of death and each subsequent year, there is a required minimum distribution. See Q&A-5(c)(1) of § 1.401(a)(9)-5 to determine the applicable distribution period for the non-spouse beneficiary. The amount not eligible for rollover includes all undistributed required minimum distributions for the year in which the direct rollover occurs and any prior year (even if the excise tax under § 4974 has been paid with respect to the failure in the prior years). See the last sentence of § 1.402(c)-2, Q&A-7(a).
(2) Special rule. If, under paragraph (b) or (c) of Q&A-4 of § 1.401(a)(9)-3, the 5-year rule applies, the non-spouse designated beneficiary may determine the required minimum distribution under the plan using the life expectancy rule in the case of a distribution made prior to the end of the year following the year of death. However, in order to use this rule, the required minimum distributions under the IRA to which the direct rollover is made must be determined under the life expectancy rule using the same designated beneficiary.

Q-18. How is the required minimum distribution with respect to a non-spouse beneficiary determined if the employee dies on or after his or her required beginning date?
A-18. If an employee dies on or after his or her required beginning date, within the meaning of § 401(a)(9)(C), for the year of the employee's death, the required minimum distribution not eligible for rollover is the same as the amount that would have applied if the employee were still alive and elected the direct rollover. For the year after the year of the employee's death and subsequent years, see Q&A-5 of § 1.401(a)(9)-5 to determine the applicable distribution period to use in calculating the required minimum distribution. As in the case of death before the employee's required beginning date, the amount not eligible for rollover includes all undistributed required minimum distributions for the year in which the direct rollover occurs and any prior year, including years before the employee's death.

Q-19. After a direct rollover by a non-spouse designated beneficiary, how is the required minimum distribution determined with respect to the IRA to which the rollover contribution is made?
A-19. Under § 402(c)(11), an IRA established to receive a direct rollover on behalf of a non-spouse designated beneficiary is treated as an inherited IRA within the meaning of §

408(d)(3)(C). The required minimum distribution requirements set forth in § 401(a)(9)(B) and the regulations thereunder apply to the inherited IRA. The rules for determining the required minimum distributions under the plan with respect to the non-spouse beneficiary also apply under the IRA. Thus, if the employee dies before his or her required beginning date and the 5-year rule in § 401(a)(9)(B)(ii) applied to the non-spouse designated beneficiary under the plan making the direct rollover, the 5-year rule applies for purposes of determining required minimum distributions under the IRA. If the life expectancy rule applied to the non-spouse designated beneficiary under the plan, the required minimum distribution under the IRA must be determined using the same applicable distribution period as would have been used under the plan if the direct rollover had not occurred. Similarly, if the employee dies on or after his or her required beginning date, the required minimum distribution under the IRA for any year after the year of death must be determined using the same applicable distribution period as would have been used under the plan if the direct rollover had not occurred.

Information – Section 845 of PPA '06
Code § 402(l), which was added by § 845(a) of PPA '06, provides for an exclusion from gross income for distributions from certain retirement plans (referred to in this notice as "Eligible Government Plans") used to pay qualified health insurance premiums of an eligible retired public safety officer. The exclusion applies with respect to an eligible retired public safety officer who elects to have qualified health insurance premiums deducted from amounts distributed from an Eligible Government Plan and paid directly to the insurer. Qualified health insurance premiums include premiums for accident and health insurance or qualified long-term care insurance contracts for the eligible retired public safety officer and his or her spouse and dependents. The distribution is excluded from gross income to the extent that the aggregate amount of the distributions does not exceed the amount used to pay the qualified health insurance premiums of the eligible retired public safety officer and his or her spouse and dependents. An "Eligible Government Plan" is a governmental plan described in § 414(d) that is either: a § 401(a), § 403(a), or § 403(b) plan; or an eligible governmental plan under § 457(b). Section 402(l) applies to distributions in taxable years beginning after December 31, 2006.

Q-20. Who is an eligible retired public safety officer for purposes of the exclusion under § 402(l)?
A-20. An employee is an eligible retired public safety officer for purposes of the exclusion under § 402(l) only if the employee is an individual who 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 the distributions to pay qualified health insurance premiums are made. Thus, a public safety officer who retires before attainment of normal retirement age is not an eligible retired public safety officer unless the public safety officer retires by reason of disability. The terms of the Eligible Government Plan from which the participant will be receiving the distributions apply in determining whether a public safety officer has separated from service by reason of disability or after attainment of normal retirement age.

Q-21. Who is a public safety officer?
A-21. For purposes of § 402(l), the term "public safety officer" means an individual serving a public agency in an official capacity, with or without compensation, as a law enforcement officer, a firefighter, a chaplain, or as a member of a rescue squad or ambulance crew. See § 1204(9)(A) of the Omnibus Crime Control and Safe Streets

Act of 1968 (42 U.S.C. 3796b(9)(A)).

Q-22. Under what circumstances are the provisions of § 402(l) available for eligible retired public safety officers?
A-22. The favorable tax treatment under § 402(l) is available only when an eligible retired public 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. The employer sponsoring the Eligible Government Plan is not required to offer such an election.

Q-23. Can the accident or health plan receiving the payments of qualified health insurance premiums be a self-insured plan?
A-23. No. The accident or health plan must be an accident or health insurance plan. Thus, the plan must be providing insurance issued by an insurance company regulated by a State (including a managed care organization that is treated as issuing insurance).

Q-24. Will an eligible retired public safety officer be entitled to favorable tax treatment under § 402(l) with respect to benefits attributable to service other than as a public safety officer?
A-24. Yes. Benefits attributable to service other than as a public safety officer are eligible for favorable tax treatment under § 402(l), as long as the individual separates from service as a public safety officer, by reason of disability or after attainment of normal retirement age, with the employer maintaining the Eligible Government Plan.

Q-25. If an eligible retired public safety officer dies, are amounts subtracted from distributions made to the decedent's surviving spouse or dependents eligible for favorable tax treatment under § 402(l)?
A-25. No. Section 402(l) provides that the distribution is not includible in the gross income of an employee who is an eligible retired public safety officer. Thus, the exclusion would not extend to amounts subtracted from distributions to other distributees.

Q-26. Is an eligible retired public safety officer limited in the amount that the officer can exclude from gross income for distributions from an Eligible Government Plan used to pay qualified health insurance premiums?
A-26. Yes. The aggregate amount that is permitted to be excluded, with respect to any taxable year, from an eligible retired public safety officer's gross income by reason of § 402(l) is limited to $3,000. For purposes of applying this $3,000 limitation, distributions with respect to the eligible retired public safety officer that are used to pay for qualified health insurance premiums from all Eligible Government Plans are aggregated.

Q-27. Are amounts used to pay qualified health insurance premiums that are excluded from gross income under § 402(l) taken into account for purposes of determining the itemized deduction for medical care expenses under § 213?
A-27. No. Amounts used to pay qualified health insurance premiums that are excluded from gross income under § 402(l) are not taken into account in determining the itemized deduction for medical care expenses under § 213.

Information – Section 904 of PPA '06

Prior to the effective date of PPA '06 § 904, a defined contribution plan satisfied the minimum vesting requirements of Code § 411(a) with respect to employer non- elective contributions if it maintained a 5-year vesting schedule or a 3 to 7 year vesting schedule. Section 904 of PPA '06 amended the minimum vesting requirements to require faster vesting of employer non-elective contributions to a defined contribution plan. Under Code § 411(a)(2)(B) as amended by § 904 of PPA '06, a defined contribution plan satisfies the minimum vesting requirements with respect to employer non-elective contributions if it has a 3-year vesting schedule or a 2 to 6 year vesting schedule. Code § 411(a)(2)(B) as amended by § 904 of PPA '06 generally applies to contributions for plan years beginning after December 31, 2006.

Q-28. If a plan amendment changes the plan's vesting schedule to satisfy Code § 411(a)(2)(B) as amended by § 904 of PPA '06, is the plan amendment required to satisfy § 411(a)(10).?
A-28. Yes. A plan amendment that changes the vesting schedule must satisfy Code § 411(a)(10). Although § 411(a)(10)(B) would require a participant with at least 3 years of service to elect to have the non-forfeitable percentage of his accrued benefit determined without regard to the amendment, the plan must ensure that any such election satisfies the vesting requirements of § 411(a)(2)(B), as amended by § 904 of PPA '06. Thus, such a participant must be provided, at all times, a vesting percentage that is no less than the minimum under a vesting schedule that satisfies § 904 and the vesting percentage determined under the plan without regard to the amendment. Under Temporary Regulation § 1.411(a)-8T, no election need be provided for any participant whose non-forfeitable percentage under the plan, as amended, at any time cannot be less than such percentage determined without regard to such amendment.

Q-29. Can a plan have separate vesting schedules for employer non-elective contributions that are and are not subject to Code § 411(a)(2)(B), as amended by § 904 of PPA '06?
A-29. Yes. A plan can have a vesting schedule for employer non-elective contributions for plan years beginning after December 31, 2006, and another vesting schedule for other employer non-elective contributions under the plan, provided that the plan separately accounts for the contributions made under the vesting schedule in effect prior to the first day of the first plan year beginning after December 31, 2006, and the vesting schedule for employer non-elective contributions for plan years beginning after December 31, 2006, satisfies Code § 411(a)(2)(B), as amended by § 904 of PPA '06.

Q-30. If a plan maintains a bifurcated vesting schedule, how is it determined whether a contribution is for a plan year beginning before January 1, 2007?
A-30. A contribution is for a plan year that begins before January 1, 2007, if it is allocated under the terms of the plan as of a date in that plan year and is not subject to any conditions that have not been satisfied by the end of that plan year. This applies even if the contribution is not made until the next plan year. Thus, for example, if a plan with a calendar-year plan year makes a contribution as of December 31, 2006, based on compensation and service in 2006, and the contribution is not contingent on the occurrence of an event after 2006, then the contribution is treated as made for the 2006 plan year and is not subject to Code § 411(a)(2)(B), as amended by § 904 of PPA '06, even if it is not contributed until 2007. Forfeitures and ESOP allocations from a suspense account are treated in the same manner for this purpose.

Information – Section 1102 of PPA '06
Section 1102 of PPA '06 makes certain changes to the notice requirements related to distributions. Section 1102(a) provides that a notice required to be provided under § 402(f), § 411(a)(11), or § 417 may be provided to a participant as much as 180 days before the annuity

starting date. Section 1102(b) directs the Secretary to modify the regulations under § 411(a)(11) of the Code and § 205 of ERISA to provide that the description of a participant's right to defer a distribution must also include a description of the consequences of failing to defer receipt of a distribution. The modifications made by § 1102 apply to years beginning after December 31, 2006. However, § 1102(b)(2)(B) provides that a plan will not be treated as failing to meet the new requirements under § 1102(b) if the plan administrator makes a reasonable attempt to comply with the new requirements under that section during the period that is within 90 days of the issuance of regulations required by § 1102(b).

Q-31. How does the effective date of § 1102 operate?
A-31. The provisions of § 1102 apply to plan years that begin after December 31, 2006. This means that the new rules relating to the content of the notices apply only to notices issued in those plan years, without regard to the annuity starting date for the distributions. Similarly, the 180-day period for distributing notices applies to notices distributed in a plan year that begins after December 31, 2006. This change to the 180-day period also modifies the definition of the maximum QJSA explanation period under § 1.411(d)-3(g), which is used in applying the timing rules for the effective date of a plan amendment under the rules of § 1.411(d)-3(c) and (f) in the case of an amendment that is adopted in a plan year that begins after December 31, 2006.

Q-32. Is a plan required to revise the notice under § 411 pursuant to the modifications made by § 1102(b) before the regulations are amended to reflect the requirement?
A-32. Yes. A plan administrator is required to revise the notice under § 411 to reflect the modifications to the requirements made by § 1102(b) for notices provided in plan years beginning after December 31, 2006. However, pursuant to § 1102(b)(2)(B) of PPA ’06, a plan will not be treated as failing to meet the new requirements under § 1102(b) if the plan administrator makes a reasonable attempt to comply with the new requirements under that section in the case of a notice that is provided prior to the 90th day after the issuance of regulations reflecting the modifications required by § 1102(b).

Q-33. Is there a safe harbor available to a plan administrator that would be considered a reasonable attempt to comply with the requirement in § 1102(b)(1) that a description of a participant’s right to defer receipt of a distribution include a description of the consequences of failing to defer?
A-33. Yes. A description that is written in a manner reasonably calculated to be understood by the average participant and that includes the following information is a reasonable attempt to comply with the requirements of § 1102(b)(2)(B): (a) in the case of a defined benefit plan, a description of how much larger benefits will be if the commencement of distributions is deferred; (b) in the case of a defined contribution plan, a description indicating the investment options available under the plan (including fees) that will be available if distributions are deferred; and (c) the portion of the summary plan description that contains any special rules that might materially affect a participant’s decision to defer. For purposes of clause (a), a plan administrator can use a description that includes the financial effect of deferring distributions, as described in § 1.417(a)(3)-1(d)(2)(i), based solely on the normal form of benefit.

Information – Section 1201 of PPA ’06
Section 1201(a) of PPA ‘06 adds § 408(d)(8) to the Code, which is applicable to distributions made in taxable years 2006 and 2007. Under § 408(d)(8), generally, if a distribution from an IRA owned by an individual after the individual has attained age 70½ is made directly by the trustee

to certain organizations described in § 170(b)(1)(A), the distribution is excluded from gross income. The exclusion is only available to the extent that the distribution would otherwise have been includible in gross income, and § 408(d)(8)(D) provides a special rule for determining the amount that would otherwise be includible in gross income. In addition, the exclusion applies only if the contribution would otherwise qualify for a charitable contribution deduction under § 170 (without regard to the percentage limitations of § 170(b)). A distribution that is eligible for this exclusion is called a qualified charitable distribution.

Q-34. Is there an overall limit on the amount that may be excluded from gross income for qualified charitable distributions that are made in a year?
A-34. Yes. The income exclusion for qualified charitable distributions only applies to the extent that the aggregate amount of qualified charitable distributions made during any taxable year with respect to an IRA owner does not exceed $100,000. Thus, if an IRA owner maintains multiple IRAs in a taxable year, and qualified charitable distributions are made from more than one of these IRAs, the maximum total amount that may be excluded for that year by the IRA owner is $100,000. For married individuals filing a joint return, the limit is $100,000 per individual IRA owner.

Q-35. Is the exclusion for qualified charitable distributions available for a distribution made to any organization eligible to receive charitable contributions that are deductible by the donor for income tax purposes?
A-35. No. Qualified charitable distributions may be made to an organization described in § 170(b)(1)(A), other than supporting organizations described in § 509(a)(3) or donor advised funds that are described in § 4966(d)(2).

Q-36. Is the exclusion for qualified charitable distributions available for distributions from any type of IRA?
A-36. Generally, the exclusion for qualified charitable distributions is available for distributions from any type of IRA (including a Roth IRA described in § 408A and a deemed IRA described in § 408(q)) that is neither an ongoing SEP IRA described in § 408(k) nor an ongoing SIMPLE IRA described in § 408(p). For this purpose, a SEP IRA or a SIMPLE IRA is treated as ongoing if it is maintained under an employer arrangement under which an employer contribution is made for the plan year ending with or within the IRA owner's taxable year in which the charitable contributions would be made.

Q-37. Is the exclusion for qualified charitable distributions available for distributions from an IRA maintained for a beneficiary if the beneficiary has attained age 70½ before the distribution is made?
A-37. Yes. The exclusion from gross income for qualified charitable distributions is available for distributions from an IRA maintained for the benefit of a beneficiary after the death of the IRA owner if the beneficiary has attained age 70½ before the distribution is made.

Q-38. If a 2006 distribution satisfies all the requirements under § 408(d)(8), but it was made before August 17, 2006 (the date PPA '06 was enacted), is the amount distributed excludable as a qualified charitable distribution?
A-38. Yes. Section 408(d)(8) is applicable to distributions made at any time in 2006. Thus, a distribution made in 2006 that satisfies the requirements under § 408(d)(8) is a qualified charitable distribution even if it was made before August 17, 2006.

Q-39. Is the amount of a qualified charitable distribution deductible as a charitable contribution under § 170?
A-39. No. For purposes of determining the amount of charitable contributions that may be deducted under § 170, qualified charitable distributions which are excluded from income under § 408(d)(8) are not taken into account. However, qualified charitable distributions must still satisfy the requirements to be deductible charitable contributions under § 170 (other than the percentage limits of § 170(b)), including the substantiation requirements under § 170(f)(8).

Q-40. Is a qualified charitable distribution subject to withholding under § 3405?
A-40. No. A qualified charitable distribution is not subject to withholding under § 3405 because an IRA owner that requests such a distribution is deemed to have elected out of withholding under § 3405(a)(2). For purposes of determining whether a distribution requested by an IRA satisfies the requirements under § 408(d)(8), the IRA trustee, custodian, or issuer may rely upon reasonable representations made by the IRA owner.

Q-41. Is a check from an IRA made payable to a charitable organization described in § 408(d)(8) and delivered by the IRA owner to the charitable organization a direct payment to such organization?
A-41. Yes. If a check from an IRA is made payable to a charitable organization described in § 408(d)(8) and delivered by the IRA owner to the charitable organization, the payment to the charitable organization will be considered a direct payment by the IRA trustee to the charitable organization for purposes of § 408(d)(8)(B)(i).

Q-42. Will a qualified charitable distribution be taken into account in determining whether the required minimum distribution requirements of §§ 408(a)(6), 408(b)(3), and 408A(c)(5) have been satisfied?
A-42. Yes. The amount distributed in a qualified charitable distribution is an amount distributed from the IRA for purposes of §§ 408(a)(6), 408(b)(3), and 408A(c)(5).

Q-43. What are the tax consequences of a direct payment of an amount from an IRA to a charity where the transaction is intended to satisfy the requirements of § 408(d)(8) but fails to do so?
A-43. If an amount intended to be a qualified charitable distribution is paid to a charitable organization but fails to satisfy the requirements of § 408(d)(8), the amount paid is treated as (1) a distribution from the IRA to the IRA owner that is includible in gross income under the rules of § 408 or § 408A, as applicable; and (2) a contribution from the IRA owner to the charitable organization that is subject to the rules under § 170 (including the percentage limits of § 170(b)).

Q-44. Will a distribution made directly by the trustee to a § 170(b)(1)(A) organization (as permitted by § 408(d)(8)(B)(i)) be treated as a receipt by the IRA owner under § 4975(d)(9)?
A-44. Yes. The Department of Labor, which has interpretive jurisdiction with respect to § 4975(d), has advised Treasury and the IRS that a distribution made by an IRA trustee directly to a § 170(b)(1)(A) organization (as permitted by § 408(d)(8)(B)(i)) will be treated as a receipt by the IRA owner under § 4975(d)(9), and thus would not constitute a prohibited transaction. This would be true even if the individual for whose benefit the IRA is maintained had an outstanding pledge to the receiving charitable organization.

SEC - Speech Before the 2006 AICPA National Conference on Current SEC and PCAOB Developments

Background

On December 13, 2006 SEC Staffer Cheryl K. Tjon-Hing provided a speech at the AICPA National Conference on current SEC and PCAOB Developments. Her speech is focused on the understanding of various issues associated with fair value measurements and reporting requirements. Below are comments from Ms. Tjon-Hing's speech.

Comments

Many of the fair value measurement issues we see at the Commission can be characterized as a subset of one overarching problem: an insufficient understanding of how certain guidance, in current authoritative accounting literature, may impact fair value methodologies and assumptions. Now, when I say an "insufficient understanding", I mean that preparers of certain fair value measurements (that is, management which may also include a retained valuation specialist), and/or their auditors, were unaware of certain relevant accounting guidance that affected the fair value measurements in question.

At this time, it seems appropriate to remind everyone that fair value is a financial reporting concept. I say that because, well for one thing, fair value is defined in Financial Accounting Standards ("FAS"), most recently FAS 157. In addition, when certain accounting guidance is established, such as there should be no consideration of blockage discounts in derivations of fair value, the term fair value starts to distinguish itself from other traditional valuation premises such as fair market value. Thus, it follows that to come up with a particular appropriate fair value measurement for financial reporting purposes, one would need to understand all the relevant accounting guidance that would affect that measurement. Unfortunately, we are seeing far more cases in which this knowledge is clearly lacking.

Let me give you a few examples of some of the problems we are seeing:

Exclusion of Tax Amortization Benefits

Tax amortization benefits (TAB) represents, as its name implies, the cash flow generated to an owner of an asset as a result of being able to write-off the full fair value of that asset for tax purposes — generally, this benefit may impact a fair value conclusion, derived using an income approach, by as much as 20% to 30%. Now, it seems logical that the fair value of an asset should not change just because of the way a transaction is structured. So TABs should be taken into account, in determining asset fair values, no matter what the tax attributes of a transaction are. But for those requiring more specific guidance, FAS 109, paragraph A129 implicitly states that TABs should be factored into an asset's fair value. To the extent that a portion of the step-up value is not deductible for tax purposes, that is what deferred tax liabilities are for. In fact, preparers of fair value measurements should be aware that if a TAB is not factored into the fair value of an asset, there may be a mismatch if any associated deferred tax liability is recorded, for accounting purposes, in an acquisition transaction. Now, despite the aforementioned accounting guidance, we often see that TABs are excluded from asset fair values measured for business combinations effected through a purchase of shares — usually, this is because preparers argue that any step-up in fair value over tax value is not deductible for tax purposes.

Fair Value of Compound Embedded Derivative Instruments

In another example, FAS 133 requires that embedded derivatives be separated from their host contract and accounted for as a separate instrument at fair value (unless a fair value election is made pursuant to FAS 155). Where a single, hybrid financial instrument with multiple embedded derivative features is involved, DIG Issue No. B15 clearly states that those features must be bundled into a single, compound embedded derivative instrument. Hence, based on this accounting requirement, it follows that those features should also be measured at fair value accordingly; that is, in a single valuation model. However, once again, despite the clear accounting guidance, we often see separate fair value measurements derived for each embedded derivative component which are then added together for accounting purposes. Not only is this inconsistent with the accounting literature, but it likely produces an inappropriate valuation since multiple options in the same document would usually affect each others' values, in way that cannot be captured if each option is valued separately. Often when we point this out to registrants, a more complex valuation model is required than was originally used to value each of the individual embedded derivative components.

Quality Fair Value Measurements

The aforementioned examples, as well as others not discussed here, have nothing to do with differences in professional judgment or reliability of measurement. Instead, it is clearly the case that the derived fair value measurements are inconsistent with guidance as set out in authoritative accounting literature.

This problem may only grow as more and more financial accounting standards and related guidance are issued that may have an impact on fair value measurements. Especially, since relevant guidance is also written, more subtly, in the form of accounting requirements and, thus, it is up to preparers of fair value measurements to pick out what aspects of the accounting standards and related guidance may impact a particular fair value measurement.

This may not be so easy a task as not all relevant guidance is labeled, "fair value implications — so please read". While FAS 157's title, "Fair Value Measurements" makes it pretty clear that it should be read by fair value measurement preparers and reviewers; it may not be so clear, for example, that FAS 109, "Accounting for Income Taxes" also has, although implicitly, fair value measurement guidance written into it.

Preparing quality fair value measurements requires not just a competency in valuations (the level of which may vary depending upon what is being valued), but also an understanding of relevant accounting literature.

I would like to remind you that it is management's responsibility to ensure that fair value approaches and assumptions are consistent with authoritative accounting guidance. If, in preparing their fair value measurements, management feels it does not have the competency to carry out this task, in its entirety, then they should consider retaining appropriate services such as those of a valuation specialist.

However, as noted before, some of the relevant fair value guidance may not be that obvious as they may be obscured by accounting requirements. As such please be aware that it is our experience that retained valuation specialists may or may not be that familiar with all the relevant accounting literature impacting fair value measurements. But, that is understandingly so — historically, for example, deferred taxes is not a topic typically found in valuation curriculums; just as contingent claims analysis is not a concept familiar to many accountants.

Nevertheless, management still needs to ensure that the valuation and accounting competencies are appropriately combined.

Now, I want to make it very clear that I am in no way suggesting that valuation specialists should all of a sudden rush out and make interpretations about accounting literature — far from it. Rather, management should gain an understanding of where the valuation specialist's core competencies lie and plan accordingly. It may be the case, for example, that management, whom is knowledgeable in accounting, may need to work more closely with the valuation specialist to ensure quality fair value measurements are derived.

Auditors also need to keep abreast of accounting guidance that will impact fair value measurements in order to properly audit those measurements.

Conclusion

Whatever the way forward, it should not be left up to the SEC staff to point out these type of, what I would describe as, "non-subjective" fair value issues to preparers and reviewers of fair value measurements in order for compliant values to be provided to investors.

EBSA - U.S. Labor Department Seeks Comments on Investment Advice Exemption for 401(k) Plans and IRAs

Background

On December 1, 2006 the U.S. Department of Labor's Employee Benefits Security Administration (EBSA) announced the publication of two "requests for information" (RFI) to assist the department in implementing the investment advice statutory exemption under the Pension Protection Act (PPA of '06) relating to 401(k)-type plans and individual retirement accounts (IRAs). The RFIs were published in the December 4, 2006 Federal Register.

The PPA of '06 amended the Employee Retirement Income Security Act (ERISA) by adding a new prohibited transaction exemption that allows greater flexibility for investment advisers to give advice to participants of 401(k) plans and IRAs.

Information

One of the ways in which investment advice may be given under the exemption is through the use of an unbiased computer model. The computer model must be certified by an independent expert under rules to be prescribed by the department. The RFI on investment advice for 401(k)-type plans solicits information to assist the department in determining what expertise and procedures may be needed to qualify an expert to certify a computer model under the exemption. The PPA of ‘06 also requires the department to issue a model notice on fee disclosures related to the advice. To aid the department in issuing this notice, the RFI also solicits information on the types of fee disclosure materials currently used and their usefulness to plan participants.

The RFI on investment advice for IRAs will assist the department in fulfilling its obligation under the PPA to assess the feasibility of using computer models to provide advice to IRA participants. The PPA of ‘06 requires the department to solicit information from at least the top 50 IRA trustees and other entities offering computer model investment advice programs. A separate copy of the RFI, in addition to its publication in the Federal Register, will be provided to those entities so identified to ensure their receipt.

Conclusion

While the comment period ended on January 30, 2007 you should be aware the proposed guidance on these items will be forthcoming and an additional comment period will more than likely be available.

SEC - Chicago Hedge Fund Manager, John M. Fife, and Clarion Management, LLC Charged With Fraud

Background

On January 18, 2007, the Securities and Exchange Commission (Commission) filed a complaint in the United States District Court for the Northern District of Illinois against John M. Fife (Fife) and Clarion Management, LLC (Clarion Management). The complaint alleges that in 2002 and 2003, Fife and Clarion Management engaged in a fraudulent scheme to purchase variable annuity contracts issued by the Lincoln National Life Insurance Company (Lincoln) for Clarion Capital, LP (Clarion Capital) in order to engage in market timing. Clarion Capital was a Chicago hedge fund formed to market time international mutual funds available through variable annuities. According to the complaint, at all relevant times, Fife controlled Clarion Capital and carried out the scheme through Clarion Management, the hedge fund's general partner and unregistered investment adviser. Fife, age 46, is a resident of Chicago, Illinois.

Information

The complaint alleges that Fife and Clarion Management used deceptive tactics to purchase contracts and engage in market timing for the benefit of Clarion Capital. These tactics included using trusts and limited liability companies as nominee contract owners and beneficiaries to conceal Clarion Capital's financial interest in the variable annuity contracts. After the purchase of each contract, Fife and Clarion Management engaged in market timing until their activity was detected and restricted by Lincoln. The complaint also alleges that when Lincoln imposed certain trading restrictions, Fife and Clarion Management caused the trusts to surrender the contracts, and then used deceptive means to disguise the purchase of more variable annuity contracts, including using previously unused trusts and limited liability companies. Through this deception, the complaint alleges that Fife and Clarion Management made hundreds of thousands of dollars in profits for themselves at the expense of the other shareholders in the mutual funds.

The complaint alleges that Fife and Clarion Management violated Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 10b-5 thereunder. The complaint also alleges that Fife violated Section 20(a) of the Exchange Act in his capacity as the control person of Clarion Management. The relief that the Commission is seeking includes disgorgement of Fife and Clarion Management's ill-gotten gains, plus prejudgment interest, and a civil penalty against Fife.