

# Family Tax Planning Forum

By Robert S. Keebler

Notice 2007-7

When the Pension Protection Act of 2006 (PPA)<sup>1</sup> was signed into law on August 17, 2006, a great deal of excitement surrounded Act Sec. 829 and the new ability for nonspouse beneficiaries to perform rollovers of qualified plans to inherited IRAs. This excitement was somewhat dimmed by the subsequent issuance of Notice 2007-7.<sup>2</sup>

Generally, participants and surviving spouse beneficiaries may roll over amounts from qualified retirement plans, Code Sec. 403(b) annuities and IRAs to another qualified retirement plan or IRA. Under prior law, nonspouse beneficiaries were not able to roll over these inherited amounts into an IRA. As a result, they were bound by the payout provisions of the plan document. Beginning in 2007, however, Code Sec. 402(c)(11) as added by Act Sec. 829 of PPA, allows nonspouse beneficiaries to roll over, via a trustee-to-trustee transfer, from a qualified retirement plan to an inherited IRA amounts inherited as a designated beneficiary.

Because qualified plans often require more rapid distribution schedules than would otherwise be allowed under Code Sec. 401(a)(9) and the related regulations, this new provision was heralded as the end of mandated quick payouts from qualified plans. It was initially thought that if a beneficiary was forced under the five-year rule by a plan document alone, that such beneficiary could perform a rollover to an inherited IRA and thereafter be able to utilize the life expectancy method.

Unfortunately, when Notice 2007-7 was released, it became clear that the IRS was not giving all beneficiaries the opportunity to take advantage of this new rule. Table 1 summarizes the rules outlined in Notice 2007-7.



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For those who inherited a plan before 2002 and were required to take distributions under the five-year rule, no rollover is allowed because the entire amount was required to be distributed before 2007—the year Code Sec. 402(c)(11) became effective.

For those who inherited a plan in 2002 and were required to take distributions under the five-year rule, the IRS again states that no rollover is allowed. Specifically, Notice 2007-7 states that “[o]n 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.”

Accordingly, beneficiaries who inherited a qualified plan from an employee who died before 2003 and were taking distributions under the five-year rule cannot roll over the plan into an inherited IRA.

For employees who died after 2002 but before 2006, if their beneficiaries are under the five-year rule, the beneficiaries can perform a rollover but will still be subject to the five-year payout. The rollover must occur before the year containing the fifth anniversary of the employee’s death. The allowable rollover amount is, of course, the amount that has not already been distributed from the plan. A better result would have been if the IRS had allowed a corrective period as they did in Reg. §1.401(a)(9)-2, Q&A 2(b)(2) with the issuance of the final Code Sec. 401(a)(9) regulations.<sup>3</sup> This would have allowed beneficiaries who were still within the five-year payout period (and who are under this payout either by affirmative election or the plan provisions) to switch to the life expectancy rule as long as they distributed any amounts that would have been required to be distributed

under the life expectancy rule for all distribution calendar years before the year of the rollover. Unfortunately, the IRS has not provided for such a remedy.

When an employee dies in 2006 or later, however, the beneficiary has the ability to switch from the five year rule under the plan to the life expectancy method under the IRA. Notice 2007-7 outlines this special rule as follows:

**While Notice 2007-7 limited the beneficiaries who could take advantage of the life expectancy payout by performing a rollover to an IRA, Code Sec. 402(c)(11) still provides a powerful planning opportunity for beneficiaries who inherit qualified plans.**

If, under paragraph (b) or (c) of Q&A-4 of § 1.401(a)(9)-3 [optional plan provision or election by beneficiary], the 5-year rule applies, the nonspouse 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.

This issue was further clarified in a special February 13, 2007 edition of the IRS’s Employee Plans News:

Notice 2007-7, Q&A-17(c)(2), describes a special rule that is an exception to the general rule in Q&A-19 [stating that the rules for determining the required minimum distributions under the plan with respect to the nonspouse beneficiary also apply under the IRA]. If, under a plan, the 5-year rule applies for determining required minimum distributions, a nonspouse designated beneficiary

**Table 1.**

Year of Death	Applicable Payout Under the Plan	Amount Allowed to be Rolled over	Applicable Payout Under the IRA
2002 and earlier	5-year rule	None	NA—No Rollover Permitted
2003–2005	5-year rule	Amount not already distributed from Plan as long as rollover completed before year containing fifth anniversary of death	5-year rule
All	Life Expectancy	All, minus prior and current year RMDs	Life Expectancy
2006 and later	5-year rule under Reg. §1.401(a)(9)-3, Q&A 4(b) or (c) (optional plan provision or election by beneficiary)	All, minus prior and current year RMDs	Life Expectancy of Beneficiary if rollover occurs prior to the end of the year following the year of death. Otherwise, 5-year rule.

may, nevertheless, treat the plan as using the life expectancy rule provided the rollover into the IRA is made prior to the end of the year following the year of the participant's death. Thus, despite a plan provision for the 5-year rule, the nonspouse designated beneficiary is permitted to treat the plan as using the life expectancy rule both for determining the amount eligible for rollover and for determining the required minimum distributions under the IRA, but only if the rollover is made prior to the end of the year following the year of the participant's death.

As long as the rollover occurs no later than December 31 of the year following the year of the employee's death, nonspouse beneficiaries can escape the plan-mandated five-year rule by performing a rollover to an inherited IRA. This avoids the lost deferral that comes from accelerated payments.

#### **Example 1—Inherited IRA Held by Beneficiary.**

On March 15, 2006, Betty Smith passes away, naming her son Dave as sole beneficiary of her 401(k). On August 3, 2007, Dave transfers his mother's 401(k) to an inherited IRA for his benefit via a trustee-to-trustee transfer. Under PPA and Notice 2007-7, Dave is permitted to make this post-mortem transfer to an inherited IRA for his benefit, thereby allowing him to stretch the IRA withdrawals over his life expectancy.

#### **Example 2—Inherited IRA Held by Qualified Trust.** Assume the same facts as Example 1, except that Betty named a trust, for the benefit of

Dave, as beneficiary of her 401(k). In this case, the trustee would be permitted to make a post-mortem trustee-to-trustee transfer of the 401(k) into an inherited IRA for Dave's trust's benefit.

Notice 2007-7 also indicated that nonspouse rollovers will only be allowed if the plan is amended to allow for such rollovers. We are hopeful that this requirement will be eliminated in the future so that beneficiaries do not have to rely on the plan administrator amending their documents in order to perform a rollover.

Note that care must be taken in performing the trustee-to-trustee rollover. The inherited IRA must be in the name of the owner of the original retirement account and payable to the designated beneficiary of the original account, the funds must pass directly from the original plan to the IRA, and an inherited IRA can generally be used only by a beneficiary who qualifies as a "designated beneficiary."

## **Conclusion**

While Notice 2007-7 limited the beneficiaries who could take advantage of the life expectancy payout by performing a rollover to an IRA, Code Sec. 402(c)(11) still provides a powerful planning opportunity for beneficiaries who inherit qualified plans. Beneficiaries who inherit a qualified plan in 2006 or later no longer have to simply accept an unfavorable plan provision (*i.e.*, the five-year rule). Instead, assuming the plan allows it, rolling the plan into an inherited IRA by the end of the year following the year of death in order to start utilizing the life expectancy method should be an option that is seriously considered.

### **ENDNOTES**

<sup>1</sup> Pension Protection Act of 2006 (P.L. 109-280).

<sup>2</sup> Notice 2007-7, IRB 2007-5.

<sup>3</sup> Reg. §1.401(a)(9)-1, Q&A 2(b)(2) states that:

A designated beneficiary that is receiving payments under the 5-year

rule of section 401(a)(9)(B)(ii), either by affirmative election or default provisions, may, if the plan so provides, switch to using the life expectancy rule of section 401(a)(9)(B)(iii) provided any amounts that would have been required to be distributed under

the life expectancy rule of section 401(a)(9)(B)(iii) for all distribution calendar years before 2004 are distributed by the earlier of December 31, 2003 or the end of the 5-year period determined under A-2 of §1.401(a)(9)-3.

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