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NEW SAFE HARBOR 402(f) EXPLANATIONS

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Last week, the IRS issued new safe harbor explanations that plan administrators may provide to recipients of "eligible rollover distributions" from employer plans in order to satisfy Tax Code Section 402(f). In this newsletter, we will briefly revisit the Section 402(f) requirement, describe certain aspects of the model explanations, and explain why it is in a plan administrator's best interests to incorporate the new model language into its explanations – perhaps as soon as practicable, and in no event later than January 1, 2010.

Section 402(f)

Section 402(f) requires a plan administrator of a qualified retirement plan (including, but not limited to, a 401(k) plan, profit sharing plan, or defined benefit plan) to provide a written explanation to any recipient of an "eligible rollover distribution." Other Tax Code sections cross-reference Section 402(f) in order to require the same explanation with respect to eligible rollover distributions from Section 403(a) annuity plans, Section 403(b) annuity contracts, and Section 457(b) governmental plans. These explanations must describe particular items, such as: (i) the ability to directly roll over distributions; (ii) tax and withholding treatment of distributions not directly rolled over; (iii) the ability to indirectly roll over distributions; and (iv) when distributions may be subject to different restrictions and tax consequences after being rolled over. A plan administrator must provide the explanation at least 30 days (absent a waiver) but not more than 180 days before the plan makes an eligible rollover distribution. In Notice 2002-3, the IRS provided model language that, if used in an explanation, would be considered to satisfy Section 402(f).

New Model Explanations

As part of President Obama's Retirement and Savings Initiative announced last week, the IRS issued new model 402(f) explanation language in Notice 2009-68. The model language attempts to more simply present and describe the options available upon receiving an eligible rollover distribution. It also reflects changes in the law since the previous model explanation was published in IRS Notice 2002-3. For example, since that prior publication, the Economic Growth and Tax Relief Reconciliation Act ("EGTRRA") added the possibility of Roth 401(k) contributions and the automatic rollover rules. In addition, the Pension Protection Act of 2006 (the "PPA") provided the ability to directly roll amounts from an eligible retirement plan to a Roth IRA, eliminated the Section 72(t) early withdrawal penalty tax in the case of qualified reservist distributions, and gave plans the flexibility to allow nonspousal beneficiaries to make direct rollovers to inherited IRAs (which option plans are required to offer for plan years beginning in 2010 and later). These changes, and others, are reflected in the new model language.

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The IRS expressly recognized that some portions of the model notice will not apply to every plan. For example, not all plans hold after-tax contributions or employer stock, nor do they involve payments from a 457(b) governmental plan or to an eligible retired safety officer. Accordingly, Notice 2009-68 permits a plan administrator to customize the safe harbor explanation by omitting any portion that does not apply to the plan, or to provide additional information so long as it is not inconsistent with the safe harbor language. This flexibility is not new – prior guidance allowed the same type of customization – but the IS has made it easier by including portions more likely to be omitted within a “Special Rules and Options” section at the end of the model language.

Note that the IRS has actually issued *two* new safe harbor explanations. A plan administrator would use the first safe harbor explanation for a distribution that is not from a designated Roth account. A plan administrator would use the second safe harbor explanation, as you may have guessed, for a participant with a designated Roth account under the plan. What if a participant is eligible to receive an eligible rollover distribution from both a designated Roth account and from an account other than a designated Roth account? The participant should receive *both* explanations.

Use of Safe Harbor Language

A plan administrator may continue to rely on the Notice 2002-3 model language for its explanation for the remainder of 2009, *provided that it has been appropriately modified to reflect statutory changes since Notice 2002-3 was published*. There are at least three reasons most plan administrators ought to be sure to modify their 402(f) explanations no later than the end of 2009 and, in the case of many plans, as soon as practicable.

Easier to Understand. First, the new model explanations are easier to read for participants. A Section 402(f) explanation includes complicated rules, and many feared the explanations would become virtually unreadable with the addition of language to describe recent changes in the law. Treasury and the IRS were sensitive to those fears and issued what they described as a “plain-English road map” aimed at helping “workers keep their savings in tax-favored plans or IRAs until they are ready to retire, rather than withdrawing cash earlier, subject to tax penalties.” The IRS drew this new road map in a reader-friendly question-and-answer format; the old notice probably generated more questions than it answered. In short, the new language will better serve plan participants and potentially reduce the questions plan administrators receive after distributing the explanations.

Out-of-date Explanations. Second, the current explanation being used by a plan administrator may be out-of-date. As noted above, there have been several relevant changes in the law since the IRS published Notice 2002-3, which explicitly provided that its safe harbor language would cease to satisfy Section 402(f) to the extent the language would no longer accurately describe the relevant law. As also noted above, the new Notice 2009-68 reminds us that the old safe harbor language is good until December 31, 2009, only to the extent it has been appropriately modified. Accordingly, plan administrators that have continued to simply use the old model language have already not been using safe harbor language. And even if a plan administrator has updated its explanation to reflect changes in the law, its safe harbor language will lose safe harbor status on December 31, 2009.

Consistent Plan Administration. Third, although most of the PPA’s rollover changes have already become effective, many administrators may have been relying on the PPA’s delayed amendment deadline before adopting plan amendments required by the PPA. That deadline is the last day of the 2009 plan year for most plans. When plan administrators are taking steps this fall to adopt PPA amendments, there will exist a natural opportunity to ensure that plan

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language, administrative procedures, and 402(f) explanations are consistent. Of course, that review would be advantageous even for employers that have already adopted PPA amendments.

Closing

Plan administrators are not required to use the safe harbor language, but we generally think it wise to do so to the greatest extent possible. At a minimum, the new safe harbor language serves as a great starting point to ensure that a plan's Section 402(f) explanation reflects the current state of the law. If you have questions regarding the appropriate steps to take with respect to your plan in light of this new guidance, please do not hesitate to contact us. Please also keep in mind that even an explanation including the safe harbor language will need to be modified when relevant law changes. Notice 2009-68 includes an explicit reminder of that fact.