

Legislation Made Real

Legislative & Regulatory Updates brought to you
by Nationwide® and McKay Hochman Co., Inc.



First Quarter 2007



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Welcome to the second edition of the “Legislation Made Real” newsletter. At Nationwide®, we’re committed to supporting our clients’ needs. These newsletters provide you with a general overview of legislative and regulatory issues related to retirement plan administration.

Over the past year, we’ve addressed a number of legislative and regulatory matters, including:

- Introducing the capability for participants to contribute to Roth sources
- Meeting the printed participant statement requirements outlined in the Pension Protection Act of 2006
- Working to complete the Roth withdrawal capability in the second quarter of 2007

We also recognize the opportunity of the automatic features, including automatic enrollment, automatic deferrals and Qualified Default Investment Alternative (QDIA) requirements. We’re currently exploring ways to support these options, while awaiting final regulations. Expect to hear more from us about this in the future.

Finally, Nationwide is closely monitoring the series of hearings on 401(k) plan fees. We will continue to stay involved and keep you informed.

We hope you find this information useful. As always, we appreciate the opportunity to serve you.

This issue focuses on:

- **IRS Distribution Guidance — Notice 2007-7**
- **Vesting Schedule for 2007**
- **DOL Benefit Statement Guidance**



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On Your Side

IRS Distribution Guidance — Notice 2007-7

The IRS has issued guidance regarding certain distribution provisions of the Pension Protection Act of 2006 (PPA). This article addresses the new guidance for PPA §826, hardship distributions for beneficiaries; §829, rollovers for nonspouse beneficiaries; and §1102, notice and consent period for distributions.

PPA §826 — BENEFICIARY HARDSHIP

401(k) and 403(b) Plans. A 401(k) or 403(b) plan that uses the safe harbor for hardship events may make hardship distributions related to medical, tuition, and funeral expenses incurred by a primary beneficiary beginning Aug. 17, 2006. A “primary beneficiary under the plan” is defined as an individual who is a named beneficiary under the plan with an unconditional right to all or a portion of a participant’s account balance upon the death of the participant. A hardship withdrawal may not be taken for the benefit of a contingent beneficiary. Normal hardship conditions must also be satisfied (e.g., the financial need must be immediate and heavy).

MHC Comment: Plans that have adopted hardship provisions have the *option* of allowing hardship withdrawals for primary beneficiaries. Theoretically, a plan amendment to add this PPA provision does not need to be adopted until 2009. However, the IRS has still not said if it will require an interim amendment.

PPA §829 — NONSPOUSE BENEFICIARY ROLLOVER

The nonspouse beneficiary of a participant in a qualified plan or 403(b) arrangement may directly roll over a deceased participant’s balance to an inherited IRA.

Inherited IRA title. The IRA must be identified explicitly as an IRA with respect to a decedent, and the names of both the decedent and the beneficiary must be included in its title; for example, “Mary Smith as beneficiary of John Smith.”

Direct rollover rules. An inherited IRA may only be established by a direct rollover. *If a plan distribution is paid directly to a nonspouse beneficiary, the distribution is not eligible for rollover.* The distribution of an inherited benefit to a nonspouse beneficiary is not subject to the direct rollover requirements of §401(a)(31), the notice requirements of §402(f), or the mandatory withholding requirements. A plan is not required to offer a nonspouse beneficiary rollover.

The opportunity to make a direct rollover is subject to §401(a)(4). If a plan in any way limits which nonspouse beneficiaries may make direct rollovers, the plan may

be violating the nondiscrimination rules of §401(a)(4), which state that a plan’s benefits, rights, and features must be offered in a nondiscriminatory manner. *A terminating defined contribution plan is permitted to offer direct rollovers to nonspouse beneficiaries, regardless of existing plan terms.*

Trust as beneficiary. A plan may make a direct rollover to an IRA on behalf of a trust beneficiary provided the trust beneficiaries meet the designated beneficiary requirements within the meaning of the required minimum distribution (RMD) rules of §401(a)(9)(E). In this situation, the IRA must be established with the trust as beneficiary and the distribution period must be based on the life expectancy(ies) of the trust beneficiary(ies).

Death before participant reaches Required Beginning Date (RBD). The RBD is the deadline for the first required minimum distribution. If a participant dies before his or her RBD, the amount eligible for rollover with respect to a nonspouse beneficiary is determined under either the five-year rule or the life expectancy rule, as set forth in the distributing plan. No RMD is required for the year in which the participant dies under either rule.

Five-year rule. Under the five-year rule, *a nonspouse beneficiary may make a direct rollover at any time during the first four years after the year of the participant’s death.* However, no amounts may be rolled over on or after Jan. 1 of the fifth year following the year in which the participant died. The five-year rule also applies to the rollover IRA — unless the special rule below applies.

Life expectancy rule. Under the life expectancy rule, the single life expectancy table is used to determine the applicable distribution period for the nonspouse beneficiary. Undistributed RMDs (for the year in which the rollover occurs and any prior year) are not eligible for rollover.

Special rule. If the five-year rule applies, the nonspouse designated beneficiary may elect to use the life expectancy method of determining RMDs instead — but only if the account is directly rolled over before the end of the year following the participant’s year of death. Additionally, RMDs under the newly established inherited IRA must be determined using the beneficiary’s life expectancy.

Death on or after participant’s RBD. If a participant dies on or after his or her RBD, the RMD for the year of death must be paid based on the amount that

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IRS Distribution Guidance — Notice 2007-7 *(continued)*

would have been payable had the participant lived and elected a direct rollover. For years *after* the year of death, undistributed RMDs (for the year in which the direct rollover occurs, and for any prior year, including years before the employee's death) are *not* eligible for rollover.

RMDs for nonspouse beneficiaries after rollover to an inherited IRA. *An IRA established to receive a direct rollover on behalf of a nonspouse designated beneficiary is treated as an inherited IRA.* The RMD requirements of §401(a)(9)(B) and the final RMD regulations apply to the inherited IRA.

To recap, the plan rules for determining the RMD for the nonspouse beneficiary also apply to the IRA. Thus,

- If the participant dies before his or her RBD and the five-year rule applies to the nonspouse beneficiary under the plan, then the five-year rule applies to RMDs from the IRA, unless the special rule is elected.
- If the life expectancy rule applies to the nonspouse beneficiary under the plan, RMDs under the IRA must be determined using the same applicable distribution period.
- If the participant dies on or after his or her RBD, the RMD to be paid from the IRA for any year after the year of death must be determined using the same applicable distribution period that would have applied under the plan.

Latest development on rollover rules. On Feb. 15, 2007, the DOL has issued an interim final rule (proposed) to regulations under the Employee Retirement Income Security Act of 1974 (ERISA) that provides guidance and a fiduciary safe harbor for the distribution of benefits on behalf of participants or beneficiaries in terminated individual account plans, including abandoned plans. For purposes of this discussion, "eligible retirement plans" or "individual account plans" are private sector retirement plans qualified under Internal Revenue Code (IRC) Section 401(a) (including 401(k) plans) and IRC Section 403(b) tax-sheltered annuities subject to ERISA.

The DOL is amending these regulations to reflect changes enacted in the Pension Protection Act of 2006 (PPA). The PPA provided that the distribution of a benefit of a deceased plan participant from an eligible retirement

plan may be directly transferred to an individual retirement account (IRA) established on behalf of the designated nonspouse beneficiary of the participant. Specifically, the amended regulations require as a condition of relief under the fiduciary safe harbor that benefits for a missing, designated nonspouse beneficiary of eligible retirement plans be directly rolled over to an IRA. The IRA is treated as an inherited IRA.

PPA §1102 — 402(f) NOTICE AND CONSENT PERIOD FOR DISTRIBUTIONS

The 30- to 90-day period for providing participants with the 402(f) distribution notice has been expanded. For plan years beginning after Dec. 31, 2006, the new period is 30 to 180 days. This change also applies to the maximum QJSA explanation period.

Treasury must update the regulations that prescribe the content of the 402(f) distribution notice. The notice must include a description of a participant's right to defer a distribution and, in addition, explain the consequences of failing to defer a distribution.

A plan will be deemed to be in compliance if the plan administrator makes a reasonable attempt to comply with the new requirements during the period that is within 90 days of when regulations are issued revising the distribution notice under §402(f), §411, and §417.

Until then, the IRS has established a "reasonable compliance" safe harbor. The safe harbor requires that the description be written so it can be understood by the average participant. The notice must also include the portion of the summary plan description that describes any special rules that might materially affect a participant's decision to defer. In addition, for defined contribution plans, the notice must include a description of the available investment options (including fees) if distribution is deferred.

MHC Comment: The requirement to include plan investment options, including fees, negates the concept of a model 402(f) notice since each notice will now require plan specific information in addition to any "model language" provided by the IRS.

Vesting Schedule for 2007

Under Section 904 of the Pension Protection Act of 2006 (PPA) and IRS Notice 2007-7, defined contribution plans may not have a vesting schedule that is longer than a six-year graded or three-year cliff schedule. These schedules are also known as the top-heavy vesting schedules.

This change, which expands the EGTRRA vesting rules applicable to matching contributions to cover employer nonelective contributions (other than safe harbor contributions, QNECs, and QMACs, which must be 100% vested), is effective for plan years that start after Dec. 31, 2006. It applies only to employees who work at least one hour after that date and only to contributions made for plan years beginning on or after Jan. 1, 2007. Thus, the vesting of an employee who terminated service prior to Jan. 1, 2007, under a seven-year graded schedule does not have to be accelerated to a six-year graded schedule.

These changes in vesting requirements raise questions about whether the current GUST plan document should be amended, and, if so, about the timing of the adoption.

Legally, PPA indicates that no amendments are required until the 2009 plan year. However, a plan must operate in conformance with the law, even if it is not amended. A plan sponsor has the option of amending to a top-heavy or faster vesting schedule *and* applying that schedule to all contributions made to the plan, including those made to eligible participants before 2007. This would simplify recordkeeping and be more cost efficient than administering two different vesting schedules (based on contribution date) for the same participant. If the plan's entire vesting schedule is upgraded, the new schedule could be applied only to those who work at least one hour after the amendment's effective date to avoid extending more rapid vesting to terminated employees.

PRE-PPA

Plans with five-year cliff or seven-year graded schedules may continue to apply those schedules to contributions made for plan years before 2007. Thus, a contribution made in 2007 for the 2006 plan year may be made under the old vesting schedule.

Similarly, if a participant in a plan with a last-day accrual rule terminates before the last day of the 2007 plan, any contributions made for years prior to 2007 also may remain subject to the five-year cliff or seven-year graded vesting schedule because the employee would not

receive a contribution for the 2007 plan year.

PROTECTION OF VESTED BENEFIT

When a plan vesting schedule is amended, there are two things to keep in mind. One is that a participant's vested benefit earned up to the point of the amendment is protected and may not be reduced. The second is that when a plan vesting schedule is changed to a schedule that provides a lower vested percentage, participants with three or more years of vesting service must be given the choice of remaining on the old vesting schedule or going to the new one.

AMENDING A PLAN VESTING SCHEDULE

If an employer decides to amend the vesting schedule for contributions made before the 2007 plan year, then participants with three or more years of service must be notified and given the right to choose between the two schedules, unless the new schedule provides for equal or increased vesting at each step. For example, if a plan is changing from a five-year cliff to a five-year graded vesting schedule, participants with three or more years of service need not be given the right to choose. Changing from a five-year cliff to a three-year cliff is a nonevent since all participants with three or more years of service become 100% vested, and no notice is required.

If a plan amends from a five-year cliff to a six-year graded vesting schedule, an interesting situation arises. While the new schedule provides for equal or increased vesting in years one through four, there is a reduction in vested percentages in year five. So the change to the six-year vesting schedule is not an issue for employees with less than three years of vested service at the time of the amendment. However, it is an issue for those with three or four years of vested service at the time of the amendment. Under IRS regulations, those employees would receive the better of the two schedules. Thus, their vesting would be 40% after three years, 60% after four years, and 100% after five years. Those with five or more years of vesting service at the time of the amendment are unaffected, since they would already be fully vested.

IRS Notice 2007-7 reminds us of the rules protecting vesting and the required notice for those with three or more years of service.

DOL Benefit Statement Guidance

The Pension Protection Act of 2006 (PPA) requires individual account plans that permit participants to direct their own investments to issue account statements at least quarterly. If participants do not direct their own investments, an annual statement is required. PPA also increases the amount of information that must be provided in pension benefit statements. The recent guidance from the DOL, FAB 2006-3, provides good faith compliance measures pending final regulations.

GOOD FAITH COMPLIANCE

Until further guidance is issued, plans may use multiple documents or sources to supply benefit statement information. However, participants and beneficiaries must be provided with an easily understandable explanation of how and when all the information will be provided in advance of the first PPA statement.

Pension benefit statements may be provided electronically if “measures reasonably calculated to ensure actual receipt” are used. This means that the final regulations for electronic notices (recently issued by the IRS) must be followed. Alternatively, statements may be provided continuously via a website. If a plan uses electronic delivery for statements, participants must be informed that they may request a paper copy of their statement at no charge. The plan or the plan administrator may be assessed a charge for the paper copy.

QUARTERLY STATEMENTS (PARTICIPANT DIRECTED PLANS/ACCOUNTS)

Benefit statements for participant directed plans must include “an explanation of any limitations or restrictions on any right of the participant or beneficiary under the plan to direct an investment.” The DOL interprets this statement to mean limitations or restrictions imposed “under the plan,” not limitations or restrictions imposed by investment funds, other investment vehicles, or by state or federal securities laws.

Quarterly statements must be provided within 45 days after the end of each quarter, starting March 31, 2007.

DISCLOSURE OF INVESTMENT PRINCIPLES

Benefit statements for participant directed plans also must include “an explanation . . . of the importance, for the long-term retirement security of participants and beneficiaries, of a well-balanced and diversified investment portfolio, including a statement of the risk that holding more than 20 percent of a portfolio in the security of one entity (such as employer securities) may not be adequately diversified.”

The DOL has provided model language for this disclosure, and it includes a link to the new DOL web page on investment principles: www.dol.gov/ebsa/investing.html.

DIVESTITURE AND DIVERSIFICATION NOTICE

If the participants and beneficiaries in an individual account plan holding company stock had divestiture and diversification rights *at least* equal to the new PPA requirements prior to Jan. 1, 2007, the divestiture/diversification notice requirement may be satisfied when the first quarterly statement is provided. The DOL took the position that a stand-alone disclosure may only cause confusion and result in additional costs for participants and beneficiaries for plans that already permitted PPA-like divestiture/diversification rights.

ANNUAL STATEMENTS (EMPLOYER DIRECTED PLANS/ACCOUNTS)

Calendar-year plans. For calendar-year plans with employer directed investments, the first annual statement must be provided no later than 45 days after Dec. 31, 2007.

Off-calendar-year plans. FAB 2006-3 says the statement deadline for off-calendar-year plans with employer directed investments is 45 days after the end of the *calendar* year, with the first statement due 45 days after Dec. 31, 2007. The good news is that the first deadline is about a year away, which gives the DOL time to revise its good faith compliance.

It is believed that the deadline should relate to the *plan* year for an off-calendar-year plan, and that the DOL will need to revise their guidance accordingly.

Here is an illustration of why. Suppose an employer has a simple balance forward plan with an annual valuation and no participant investment direction. We would agree that the rules for a calendar-year plan say that the statement reflecting the Dec. 31, 2007 balance must be distributed by Feb. 15, 2008. But suppose the plan year ends on Jan. 31, 2008. The DOL good faith guidance proposes that the employer will still be required to issue a statement of participant accounts by Feb. 15, 2008. We don't believe this is what the DOL meant to say.

Annual statement balance forward plans often need two or three months to reconcile transactions, assets, and participant level accounting, and generate statements.

It is anticipated that the DOL will revise its good faith rule for annual statements for off-calendar-year plans. In the past, the DOL has released guidance and corrected it

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DOL Benefit Statement Guidance *(continued)*

because of impractical requirements or other problems with its original form. The DOL will likely change the guidance before it becomes effective. In all fairness to the DOL, they were under pressure to quickly release the guidance.

MHC Comment: The new guidance appears to be problematic for annually valued plans maintained with balance forward recordkeeping, since it is likely that they have not previously been valued within 45 days after the close of the plan year, and much of the information needed to create the statement may not be available at that time.

For more information on how Nationwide® can help you meet some of these new obligations, please refer to the Jan. 19, 2007 Points of Interest.

This information is of a general and informational nature and is NOT INTENDED TO CONSTITUTE LEGAL, TAX OR INVESTMENT ADVICE. Rather, it is provided as a means to inform you of current information about legislative, regulatory changes, and other information of interest. The information is based on current interpretations of the law and is not guaranteed. Neither the company nor its representatives give legal or tax advice. Please consult your attorney or tax advisor for answers to specific questions.

Questions?

If you're a plan administrator, call your account manager at 1-800-548-6436.

If you're an investment professional, call your internal retirement plan consultant at 1-800-626-3112, option 1.

If you're a plan sponsor, call your plan administrator or investment professional.



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