CCH Tax Briefing:

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# WORKER, RETIREE, AND EMPLOYER RECOVERY ACT OF 2008

*Special Report*

## New Law Statistics:

- ✔ *40-Plus Major Provisions*
- ✔ *Over 130 Tax Code Changes*
- ✔ *Suspension of RMDs*
- ✔ *Required Non-Spouse Rollovers*
- ✔ *Funding Relief for Employer-Sponsored Plans*
- ✔ *Special Deduction Dates for Small Plans*
- ✔ *Hybrid Plan Relief*
- ✔ *Higher S Corp Partnership Penalties*
- ✔ *Effective Dates Spanning 2003-2010*

## Inside



# Congress Passes Emergency Pension Tax Relief/Technical Corrections

The continuing drumbeat of bad economic news has spurred the lame-duck Congress to pass an emergency package of pension recovery provisions and pension-related technical corrections. The *Worker, Retiree, and Employer Recovery Act of 2008* ( H.R. 7327), approved by Congress on December 11, suspends required minimum distributions (RMDs) from 401(k) plans, IRAs and similar retirement accounts for 2009, provides pension plan funding relief, and includes long-awaited technical corrections to the *Pension Protection Act of 2006 (PPA)* (P.L. 109-280). President Bush is expected to sign the *Worker, Retiree, and Employer Recovery Act* as soon as it reaches his desk.

This year-end round of tax legislation foreshadows much more tax legislation, first in the form of a large stimulus bill, expected to be unveiled by the 111th Congress before President-elect Barack Obama takes office. Pension benefits experts also forecast that the *Worker, Retiree, and Employer Recovery Act* represents only the first step in shoring up retirement plans, with further relief likely in 2009.

**Impact** *The pension package was pushed through Congress before year-end largely in response to two immediate concerns: (1) the inability of many pension plans to meet new funding obligations that would lead to frozen plans and business cutbacks and (2) the hardship placed on many retirees if they were forced to take RMDs when their retirement savings are at their lowest point in years.*

**Impact** *Two powerful business tax breaks were removed from the final version of the new law: extensions of 50-percent business depreciation and increased Code Sec. 179 expensing. Although both incentives are on track to terminate at the end of 2008, chances remain very good that these tax incentives will be extended into 2009, retroactively in the stimulus bill set for passage in January under the new Obama Administration.*

## REQUIRED MINIMUM DISTRIBUTIONS

Many retirees, especially those who have recently retired, have been rocked by the nose-dive in value of their retirement savings accounts since September. Existing tax rules would have forced them to further deplete their tax-deferred nest eggs when they are at their lowest by taking RMDs from their qualified plans or IRAs.

The new law suspends RMDs from qualified retirement accounts for 2009. RMDs for 2008 are *not* waived by the new law.

**Impact** *A Treasury Department spokesperson told CCH that the Treasury is aware of the problems* *surrounding RMDs for 2008 and depleted retirement assets. The Treasury is "looking at this issue but we have no timeframe for any decisions or announcements," the spokesperson said. The Treasury could issue administrative relief, ameliorating the impact of RMDs for 2008.*

Ordinarily, by April 1 of the calendar year following the year in which an individual reaches age 70½, the remaining balance in any tax-deferred retirement savings account (401(k) plan, 403(b) plan, IRA, etc.) must be distributed to the individual in full or the individual must begin to receive RMDs from the account. For years subsequent to the first year of retirement, RMDs ordinarily must be made by the end of the current year. In either case, RMDs are calculated based on the account's balance as of the last business day of the year *prior* to the year for which the RMD must be made. The IRS imposes an excise tax of 50 percent to the extent a RMD in the proper amount is not made. Under the new law, that excise tax is waived on all 2009 RMDs underpayments ordinarily distributed to retirees.

***Example.*** *Laura Jones, a retiree in the 28-percent tax bracket, is required to withdraw $10,000 from her IRA as a RMD. Laura does not make the RMD. The IRS under the permanent rules would impose a 50-percent excise tax ($5,000). Additionally, Laura would have been liable for $2,800 in income tax, leaving her with $2,200 to show for the $10,000 distribution.*

**Caution** *The new law does not relax the rules that discourage early distributions from IRAs and other arrangements. Some lawmakers, and Obama on the campaign trail, proposed allowing distributions of 15 percent, up to $10,000, from retirement accounts without penalty for 2008 and 2009 to help taxpayers cope with tough economic times. Those over age 59½, however, may withdraw funds from a retirement account penalty free under existing rules; they must, however, pay income tax on those withdrawals.*

**"Pension benefits experts forecast that the *Worker, Retiree, and Employer Recovery Act* represents only the first step in shoring up retirement plans, with further relief likely in 2009."**

**Comment** *The IRS issued final regulations on the determination of RMDs in 2002. The life expectancy table in the 2002 final regulations substantially lengthened the period over which RMDs are to be made when compared to both 1987 and 2001 proposed regulations.*

For all retirees, RMDs are just that: *minimum* distributions that are required. Distributions up to the full balance of the account continue to be allowed at any time without penalty, but with the usual recognition of ordinary income on the taxable amount withdrawn.

**Caution** *The new law also allows the beneficiaries not to receive distributions in 2009 for the purpose of implementing the five-year RMD schedule imposed on distributions received by beneficiaries after the death of an account holder.*

**Comment** *Distributions from an IRA that are transferred directly to a charity are excluded from the recipient's income, but count against the recipient's required minimum distribution for the year. The suspension of the required minimum distribution requirement may lead to a decrease in charitable distributions in 2009.*

## NON-SPOUSE ROLLOVERS

Before the *PPA,* the ability to roll over a decedent's interest in a qualified plan, 403(b) plan or 457 plan was limited to surviving spouses. The *PPA* extended this treatment to non-spouse beneficiaries effective for distributions after December 31, 2006. The rollover must be accomplished via a trustee-to-trustee transfer and the minimum distribution rules of Code Sec. 401(a)(9) must be followed (rather than special rules applicable only to surviving spouses). The new law clarifies that *all* plans must permit rollovers out of the plan for non-spouse beneficiaries and provide notice of the distribution.

**Impact** *In Notice 2007-7, the IRS indicated that non-spouse rollovers were not mandatory. Many lawmakers objected to the IRS's interpretation and the new law clarifies that plans are required to permit non-spouse rollovers.*

**Impact** *Effective for plan years beginning after December 31, 2009, qualified plans must permit nonspouse rollovers. Until then, the new law clarifies that they are allowed.*

**Caution** *The new law appears to confirm that, as under existing law, there is no non-spouse rollover available from IRAs.*

*Comment* *The new law also clarifies that rollover distributions do not reduce unemployment compensation. Additionally, the new law clarifies that a qualified rollover contribution to a Roth IRA from a Roth 401(k) or 403(b) is not subject to the adjusted gross income limit or other requirements applicable to rollovers from non-Roth eligible plans.*

## PUBLIC SAFETY OFFICERS

The new law extends the current $3,000 exclusion for health insurance premiums for retired public safety officers to self-funded arrangements. To be excluded, however, the amounts used to pay the premiums must be distributed from a public safety officer's former employer's retirement plan.

## PENSION PLANS

The *PPA* was enacted to strengthen defined benefit (DB) pension plans rather than accelerate the trend for businesses to eliminate them in favor of defined contribution (DC) plans or providing no retirement plans at all. Although increased funding requirements under *PPA* may have remained compatible with that goal under normal economic circumstances, many businesses suddenly cannot meet their new funding obligations without jeopardizing both their defined benefit plans and the survival of the business itself, along with the jobs that it provides. Plan administrators are coming face-to-face with a December 31st funding deadline that could not wait to be addressed in 2009 legislation.

### Single Employer Plans

***Eased funding rules.*** The *PPA* set transitional funding targets for pension plans but many employers are unable to meet even these reduced amounts because of the economic downturn. Under the new law, plans that fall below the target funding percentage for a particular year (92 percent for 2008 and 94 percent for 2009) will be required to make subsequent contributions up to the specified funding percentage for that year instead of the 100-percent amount required under the previous "cliff" provision set under the *PPA*.

*Impact* *Businesses argued that, although the eventual 100-percent funding target under PPA is both reasonable and desirable, that target was now being phased in under economic circumstances unforeseen by Congress when the PPA was enacted. Many businesses can now temporarily allocate more of their financial resources to current business operating needs.*

***Two-year smoothing.*** Prior to the *PPA*, businesses were able to recognize unexpected pension plan asset gains and losses over four years. Although the *PPA* reduced that smoothing period to two years, its application was open to interpretation. Proposed Treasury regulations would require use of the fair market value of assets to determine the level of current required funding rather than use of a smoothed value that recognizes unexpected gains and losses over two years. Especially in a slowing economy, smoothing can help lower the immediate cost of meeting certain funding levels. The new law clarifies the use of smoothing to allow the recognition of unexpected asset gains and losses over a 24-month period.

***Benefit accruals.*** To avoid restrictions on benefit accruals as a result of being less than 60-percent funded, the new law allows plans to look back to the previous plan year to determine their funding status adjusted funding target attainment percentage (AFTAP), rather than use the current year's AFTAP. This provision would apply for plan years beginning on or after October 1, 2008, and before October 1, 2009. For plan years beginning January 1, 2009, that means a look back to January 1, 2008, conditions.

*Impact* *Application of the benefit limitations will be based on the earlier year, before the market collapse of 2008.*

If the plan's funding level falls below 60 percent, Code Sec. 436 generally forbids any distributions of accelerated benefits. The new law permits lump-sum payments of $5,000 or less without participant consent, as allowed by Code Sec. 411(a)(11), even if the plan is otherwise prohibited from paying lump sums.

*Comment* *The new law also helps payouts from small defined benefit plans by determining the value of lump-sum distributions not in excess of the Code Sec. 415 limit using a fixed 5.5-percent interest rate, rather than pegging the limit at the old "greater of 5.5-percent or 105-percent of the corporate bond yield curve rate."*

### Multi-Employer Plans

The *PPA* provides additional funding rules for multi-employer plans that are in "endangered or critical status." The new law relaxes some of these funding restrictions to help multi-employer plans during the economic downturn.

For plan years beginning on or after October 1, 2008, and before October 1, 2009, the new law allows multi-employer plans to elect to freeze their current funding certification based on the previous plan year's status. If the plan was in endangered or critical status for the preceding plan year, the plan also was not required to update its funding improvement plan or schedules until the following plan year.

The new law provides a three-year extension, from 10 to 13 years, of the current funding improvement and rehabilitation period for multi-employer plans in critical or endangered status for 2008 or 2009. If the plan is in seriously endangered status, its funding improvement period is extended to 18 years rather than 15 years.

Comment *If a multi-employer plan is certified by the plan actuary to be in endangered or critical status, notification of the endangered or critical status must be provided within 30 days after the date of certification to participants and beneficiaries. The new law does not relax this or other heightened and accelerated funding notification requirements under the PPA.*

### At-Risk Plans

Under the *PPA*, plans with more than 500 participants that have a funded target attainment percentage (FTAP) in the preceding year below designated thresholds would be deemed at-risk and are subject to increased target liability for plan years beginning after 2007. The new law applies the 2008 transition rule for determining at-risk status to both the 70-percent and 80-percent prongs of the two-tiered determination of at-risk status.

Comment *A plan is at-risk if the FTAP for the preceding year is less than 80-percent and the FTAP for the preceding plan year, determined by applying the specified at-risk actuarial assumptions, is less than 70-percent. Both components of the test must apply for a plan to be treated as at-risk.*

### Small Plans

The benefit restriction rules are based upon a plan's AFTAP as of the first day of the plan year. However, a small plan (100 or fewer participants) is allowed to designate any day of the plan year as its valuation date for that plan year and succeeding plan years. The new law authorizes the Treasury and the IRS to establish special rules regarding small defined benefit plans that have an alternate valuation date for purposes of quarterly contributions and application of the benefit restrictions.

### Hybrid Plans

A hybrid plan is a defined benefit plan that combines elements of traditional defined benefit (DB) plans with elements of defined contribution (DC) plans. A cash balance plan is a type of hybrid plan that pays benefits based on a separate hypothetical account. Code Secs. 411(a)(13) and 411(b)(5), added by the *PPA*, allow the operation of cash balance plans and provide protection for older participants. The new law provides some relief for hybrid plans.

- The new vesting rules for hybrid plans would be effective on the basis of plan years and apply to participants with an hour of service after the applicable effective date for the plan.
- The new law provides that the new *PPA* interest crediting rules for hybrid plans in existence on June 29, 2005, apply to years beginning after December 31, 2007, unless the sponsor elects to apply the rules earlier.
- The new law provides that the special *PPA* effective date for the vesting and interest crediting requirements for applicable plans that are collectively bargained does not apply to plan years beginning before the earlier of: (1) the later of January 1, 2008, or the termination of the collective bargaining agreement; or (2) January 1, 2010.

### Automatic Enrollment

The *PPA* encouraged employers to adopt automatic enrollment in DB plans. The new law clarifies the permissible withdrawal rules within automatic enrollment arrangements and extends them to cover simple retirement accounts (SIMPLE IRAs under Code Sec. 408(p)) and simplified employee pensions (SARSEPs).

Impact *During the campaign, Obama proposed expanding retirement savings options for lower and middle income individuals, particularly emphasizing automatic enrollment and possibly making it mandatory rather than optional.*

### Governmental Plans

Governmental retirement plans that credit a plan participant's account balance with a specified interest rate will be permitted to use a rate that exceeded the "market rate of return" (as defined by the Treasury), provided the governmental plans' interest rate was set by federal, state, or local law.

### Combined Plan Deduction Limit

The new law modifies the overall deduction limit for employers that maintain one or more DC plans and one or more DB plans. Under the new law, if contributions to DC plans are less than six percent of compensation, the DB plan is not subject to the overall deduction limit. If contributions to DC plans exceed six percent of compensation, only defined contributions in excess of six percent are counted toward the overall deduction limit. Prior to the new law, the overall deduction limit applied to the total contributions to all plans for a plan year.

### State/Local Health Insurance Reimbursements

The new law adds a new provision to Code Sec. 105, which determines tax treatment of amounts received under accident and health plans. The new provision clarifies that amounts received back under qualifying state and local government sponsored health plans will continue to be excluded from the taxpayer's gross income, even though the plan may reimburse the health care expenses of the deceased taxpayer's beneficiary.

### Plan Expenses

The new law requires plan expenses expected to be paid out of plan assets to be included in calculating the plan's target normal cost.

## PENALTIES

Many Capitol Hill observers see "pay-go" rules, which require an equal amount of revenue raisers as tax breaks in a bill, as a thing of the past until the current economic crisis ends. As a result, the new law is not revenue neutral, although several tax breaks were in fact scored as revenue raisers under the assumption that plans would otherwise terminate without them. Two clear revenue raisers, however, were included that impact directly on S corporations and partnerships.

### S Corp Penalties

The law increases the monthly multiplier from $85 to $89 for the Code Sec. 6699(b)(1) failure-to-file penalty applicable to S corporation income tax returns. This provision applies to returns filed after December 31, 2008, and it is expected to raise an additional $38 million in revenue over the next 10 years.

### Partnership Penalties

The law increases the monthly multiplier from $85 to $89 for the Code Sec. 6698(b)(1) failure-to-file penalty applicable to partnership returns. This provision applies to returns filed after December 31, 2008, and it is expected to raise an additional $42 million in revenue over the next 10 years.

**Impact** *Use of pass-through entities, in the form of both S corporations and partnerships, has more than doubled over the past five years, as has income earned by them. As their use further increases, expect Congress to utilize compliance issues related to them as fertile grounds for collecting new revenue.*

## AND MUCH MORE:

That "the devil is in the details" is particularly apt to the *Worker, Retiree, and Employer Recovery Act*. Details in implementing temporary relief and details in fine-tuning and clarifying *PPA* provisions consume over 100 pages of bill text, which amend over 130 Internal Revenue Code provisions. Plans sponsors and administrators in particular need to be aware of the many deadlines, options and mandatory changes called for in the new law.

### Major Provisions of H.R. 7327 In a Nutshell:

- Relief for retirees from RMDs from qualified plans and IRAs
- Relief for employers from asset depreciation by clarifying permitted use of smoothing over 24 months for pension plan funding
- Relief from funding transition rules by eliminating 100-percent funding for failures
- Relief for multi-employer plans, by allowing sponsors to elect to temporarily freeze at funding status held in previous plan year
- Relief from mandatory accrual of pension benefits
- Increases in failure-to-file penalty fees for partnerships and S corps