Some Relief for Non-Spouse Beneficiaries

First, a little background. For years, non-spouse beneficiaries of employer sponsored retirement plans (401(k), 403(b) and 457 plans) have faced a major problem when inheriting these plans. Non-spouse beneficiaries typically had only two options for taking distributions: an immediate lump sum distribution, immediately taxable, or a full distribution within five years – again, fully taxable when distributed.

These rules were significantly more restrictive than the rules for a non-spouse beneficiary inheriting an IRA account. IRA rules allow non-spouse beneficiaries to "stretch out" distributions over their own life expectancy, which is a major advantage from a tax perspective, especially for younger beneficiaries who don't plan significant distributions from the account until much later in life. The power of tax-deferral over time is tremendous, so the stretch provision was a big advantage of IRAs.

Recognizing this inequity between employer sponsored retirement plans and IRAs, Congress decided to step in and came out with a provision in the Pension Protection Act of 2006 to address this issue. The Act stated that beginning in 2007, any non-spouse "designated beneficiary" could roll over any inherited retirement plan (401(k), 403(b) and 457 plan) into a properly titled inherited IRA (the newly created IRA must be titled in the name of the deceased participant payable to the beneficiary). Congress even instructed the IRS to issue rules under which a trust "for the benefit of" designated beneficiaries would be able to do these rollovers after the participant's death.

Unfortunately, the IRS' interpretation of this new law is much more restrictive than what everyone was hoping for. On January 10th, 2007, the IRS issued Notice 2007-7, which states two important things: (1) employer sponsored retirement plans are NOT required to offer the non-spouse beneficiary rollover option, and (2) if the employer sponsored retirement plan requires the non-spouse beneficiary to empty the account within five years, that rule will also apply to the inherited IRA. There is widespread disappointment in this interpretation in the financial planning community, as it could significantly limit the usefulness of the non-spousal rollover provisions of the Pension Protection Act.

Specifically, if either the employer sponsored retirement plan chooses not to allow non-spousal rollovers, or the plan participant died prior to 2006, we are back to square one in dealing with inequitable distribution rules. However, if the plan does choose to allow non-spousal rollovers, and the plan participant dies in 2006 or later, a whole new set of distribution rules and planning opportunities will be available to the non-spouse beneficiary.

So the bottom line is this: first, if you are a non-spouse beneficiary of an employer sponsored retirement plan, you may want to investigate the possibility of completing a properly executed direct rollover of plan benefits to stretch out your distributions over your life expectancy. If this situation applies to you, you will want to complete the rollover by December 31st of the year following the year of the participant's death.

Second, if you are the owner of an employer sponsored retirement plan and believe that there is any possibility that your benefits will be inherited by a non-spouse beneficiary, you should consider the option of completing a direct rollover to an IRA as soon as possible (typically after separation from service). This could eliminate the risk that the plan may choose not to allow your non-spouse beneficiary the life expectancy distribution option.

Finally, this is a new law, and changes are sure to be made as it is interpreted and implemented. Consequently, if you feel that either of these situations may apply to you, we strongly encourage you to come in and talk to us about your specific circumstances so we can better advise you on what actions, if any, you may want to consider.

-- Joe Hebert. Posted 2/15/07.