

Pension
ANALYST

Compliance Bulletin

October 2007



Excess Deferral Distributions Must Include Gap Period Income

Gap Period Income Requirement

On April 30, 2007, the IRS issued final Roth rules to provide guidance on the taxation, rollover, and reporting of distributions from designated Roth accounts. In addition to the Roth guidance, the final rules included a provision that applies to 401(k) plans and 403(b) arrangements, *even if they do not offer Roth contributions*.

The final Roth rules require that any distribution of excess deferrals include gap period income. Excess deferrals are those amounts above the 402(g) limit (\$15,500 for 2007) plus any applicable catch-up contributions. This gap period income rule applies to the distribution of all pre-tax and Roth excess deferrals. "Gap period income" is the earnings on the distribution amounts from the end of the calendar year in which the contributions were made through the date the distribution is made.

The regulations provide three alternatives for calculating gap period income:

- Any reasonable method used by the plan for determining earnings;
- Use of a formula provided in the regulations; and
- A safe harbor method that deems gap period income to be equal to 10% of the earnings for the year, multiplied by the number of months in the gap period.

In addition, daily valued plans that do not use the safe harbor method may determine gap period income as of a date that is no more than seven days before the actual distribution date.

This rule applies to excess deferrals for tax years beginning on or after 2007, which will generally be distributed on or after January 1, 2008, and will continue to apply even after the [2008 elimination of the gap period income rule](#) that applies to ADP and ACP test corrective distributions. However, it is important to note that proposed technical corrections to the Pension Protection Act of 2006 (PPA) would remove this requirement. Beginning in 2008, Prudential will include gap period income on excess deferral distributions for 401(k) plans and ERISA and non-ERISA 403(b) arrangements, unless the technical corrections bill is enacted.

Prudential's Action Steps

If your plan document currently provides for the payment of gap period income on excess deferral distributions, Prudential will continue to include gap period income on those distributions, even if the technical corrections bill is enacted. If the technical corrections bill is enacted and you want to remove this gap period income payment provision, you will have to amend your plan and notify us of this change before you direct us to make this type of distribution.

If your plan document currently does not provide for the payment of gap period income on excess deferral distributions, you will need to amend your plan (as discussed [below](#)) to comply with this rule. Prudential will include gap period income on excess deferral distributions made after December 31, 2007, for 401(k) plans and ERISA and non-ERISA 403(b) arrangements. If you do not provide specific directions for calculating gap period income, Prudential will use a method that determines the actual income on the excess deferral from the beginning of the applicable calendar year through the date of distribution.

If the gap period income payment requirement is eliminated by the technical corrections bill, Prudential will not pay gap period income on excess deferral distributions, unless your plan has been amended to include this provision. If you amend your plan before technical corrections are enacted and then want to revert to the prior plan provisions, you may need to amend your plan once again to remove the gap period income provision.

Special Plan Document Considerations

Plan amendments to include gap period income on excess deferrals, where necessary, are considered “interim amendments” which generally must be adopted by the later of:

- The due date, including extensions, for filing the employer’s tax return for the 2007 tax year; or
- The last day of the 2007 plan year.

The amendment deadline for a single-employer governmental plan is the later of the deadline described above or the last day of the next legislative session held following the effective date of the regulations. The amendment deadline for a single-employer plan maintained by a tax-exempt employer (including a nonelecting church plan) is based on the deadline for filing the employer’s Form 990. A multiple employer plan or multiemployer plan must be amended by the last day of the tenth month following the last day of the plan year that includes the effective date of these rules.

However, due to the uncertainty of the proposed technical corrections bill, plan sponsors may find it prudent to delay the adoption of plan amendments until closer to the amendment deadline in anticipation of the enactment of the technical corrections bill. In addition, plan sponsors may want to consider adopting an amendment that contains an automatic unwinding provision that takes effect if the technical corrections bill is enacted. If Prudential Retirement provides document services for your plan, we will work with you to ensure that your plan complies with the various amendment deadlines.

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