

# Pension ANALYST

Important Information

Plan Administration and Operation

February 2006



## IRS Provides KETRA Guidance

**WHO'S AFFECTED** This guidance applies to qualified plans, ERISA 403(b) plans, and governmental section 457(b) plans and to participants in those plans who were directly affected by Hurricane Katrina. It also applies to affected participants in non-ERISA 403(b) programs.

**BACKGROUND AND SUMMARY** The [Katrina Emergency Tax Relief Act of 2005 \(KETRA\)](#) provided individuals who were directly affected by Hurricane Katrina with additional access to their retirement savings to alleviate hardships caused by the arrival of this hurricane on the Gulf Coast at the end of August 2005. It also lessened the tax burdens related to these special distributions.

[IRS Notice 2005-92](#) now provides much-needed guidance regarding the special KETRA plan distribution and loan provisions, including clarification of:

- An individual's eligibility for KETRA relief;
- The types of distributions that may be classified as KETRA distributions;
- Applicable federal tax withholding and reporting rules;
- Plan loan repayment suspension provisions; and
- Plan amendment requirements.

**ACTION AND NEXT STEPS** Plan sponsors with employees or former employees in Louisiana, Mississippi, Alabama, or Florida should review this publication to become familiar with the rules that apply to KETRA distributions and loans. Plan sponsors that wish to make this relief available under their plans or programs should contact their Prudential Retirement representatives.

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## Eligibility to Take KETRA Distributions or Loans

In general, an individual is eligible to take a qualified Hurricane Katrina distribution (“KETRA distribution”) or KETRA loan from his retirement plan, or have plan loan repayments temporarily suspended if:

- His principal place of abode on August 28, 2005 is located in the Hurricane Katrina disaster area; and
- He sustained an economic loss as a result of Hurricane Katrina.

This guidance provides that the first of these two requirements is met if the individual’s principal place of abode is located *anywhere* in the states of Louisiana, Mississippi, Alabama or Florida.

The guidance also clarifies that an individual’s “principal place of abode” is simply where he lives. A temporary absence due to illness, education, business, vacation, or military service does not change an individual’s principal place of abode. If an individual’s principal place of abode was located in the Hurricane Katrina disaster area but he evacuated due to the Hurricane before August 28, 2005, he would still be considered to have a principal place of abode in the Hurricane Katrina disaster area on August 28, 2005.

Notice 2005-92 does not provide specific guidance about the “economic loss” requirement. However, it does provide that the amount of a KETRA distribution or loan does not have to correspond to the amount of the individual’s need or the amount of his economic loss. As a result, the distribution or loan may exceed those amounts. However, it appears that a plan sponsor may voluntarily impose a “need” or “loss” requirement.

Unless they have actual knowledge to the contrary, plan sponsors may rely on an individual’s “reasonable representations” that

- His principal place of abode was located in the Hurricane Katrina disaster area; and
- He suffered an economic loss as a result of the Hurricane.

The IRS does not provide examples of what would be considered reasonable representations.

## KETRA Distributions

According to this guidance, *any* distribution that is made on or after August 25, 2005, and before January 1, 2007, to an individual who meets the KETRA requirements may be designated as a KETRA distribution (and, therefore, eligible for the related special tax treatment), even if it is not made as a result of the Hurricane.

All of the following types of distributions may be considered KETRA distributions:

- Periodic payments;
- Minimum required distribution (MRD) payments;
- Plan loan offsets;
- Hardship withdrawals;
- In-service withdrawals; and
- Termination of employment or retirement distributions.

As a result, distributions made by defined benefit plans, as well as those made by defined contribution plans, may be classified as KETRA distributions. However, defined benefit and money purchase pension plans may

not permit in-service KETRA distributions. In addition, KETRA distribution payments are subject to the standard spousal consent rules where applicable.

Sponsors of 401(k) plans may amend their plans to permit the distribution of elective deferrals, qualified nonelective contributions (QNECs) and qualified matching contributions (QMACs) as KETRA distributions, even if the participant has not separated from service, become disabled or reached age 59½.

## **KETRA Distribution Processing**

Sponsors of qualified plans, 403(b) arrangements, and governmental section 457(b) plans may choose whether to treat distributions as KETRA distributions. Plan sponsors and plan administrators may develop any reasonable procedures for identifying the distributions that are to be treated as KETRA distributions. However, plans may not treat more than \$100,000 of distributions made to an individual as KETRA distributions, taking into account KETRA distributions made to the individual from other plans sponsored by members of the plan sponsor's controlled group.

KETRA distributions are not eligible for direct rollover. As a result, plan administrators do not have to provide section 402(f) rollover notices before making these distributions and the distributions are not subject to 20% federal withholding. However, they are subject to the alternative 10% voluntary withholding. They are not subject to the 10% additional tax on early distributions.

KETRA distributions must be reported on Form 1099-R, even if they are recontributed to the same plan during the same year. These distributions are automatically taxed pro-rata, over the 3-year period beginning with the year of distribution, unless the individual elects to treat the entire amount as taxable in the year he receives the distribution. In accordance with IRS guidance, Prudential will report the entire amount on Form 1099-R for the year of distribution, and leave it to the individual to choose the actual tax treatment when he files the new [Form 8915](#) with his tax return.

## **Recontribution of KETRA Distributions**

In general, KETRA distributions may be recontributed to eligible retirement plans. However, only those distributions that would normally be eligible to be rolled over may be recontributed. As a result, the following types of KETRA distributions may *not* be recontributed:

- Periodic payments for a period of at least 10 years or over the employee's life or life expectancy (or the lives or joint life expectancies of the employee and his designated beneficiary);
- MRD payments; and
- Death benefit payments made to a nonspouse beneficiary.

One important exception to this general rule is that hardship withdrawals that meet the KETRA distribution requirements may be recontributed, even though hardship withdrawals are not normally eligible to be rolled over.

Participant recontributions must be made within the 3-year period beginning on the day after the date the distribution is made. *For example, if a plan makes a KETRA distribution on January 17, 2006, the recontribution deadline would be January 18, 2009.* A different recontribution deadline applies to each KETRA distribution made to an individual. Recontributions do not have to be made to the plan that made the original distribution, and partial recontributions are permitted.

When accepting recontributions, plan sponsors and administrators must reasonably conclude that the amount is eligible for recontribution and is being made during the appropriate timeframe. Plan sponsors may rely on the individual's reasonable representations that the distribution was a KETRA distribution, unless the plan administrator has actual knowledge to the contrary. Recontributions are to be treated as direct rollover contributions. As a result, Prudential will hold these in a rollover contribution source.

## KETRA Plan Loans

The limit on KETRA loans is the lesser of \$100,000 or 100% of the participant's vested account balance, twice the standard loan limit. In a separate Press Release, the Department of Labor indicates that it will treat a KETRA loan as satisfying the ERISA adequate security and reasonably equivalent basis requirements.

KETRA also allows plan sponsors to suspend for one year loan repayments due during the period beginning August 25, 2005, and ending on December 31, 2006, if the participant meets the KETRA loan eligibility requirements. Plans are not required to provide these repayment suspensions but may choose to do so.

The IRS guidance provides a *safe harbor* for loan repayment suspensions. Under this safe harbor, a plan sponsor suspends repayments due during the period beginning August 25, 2005, and ending on December 31, 2006 (the "suspension period"). Loan repayments resume at the end of the suspension period, adjusted for the interest accruing during the suspension period, and the term of the loan is extended by the length of the suspension period.

*For example:*

- *Wilma borrowed \$20,000 on March 31, 2005, to be repaid over a 5-year period.*
- *Monthly payroll deduction repayments were \$394.*
- *Wilma made these payments until December 1, 2005.*
- *Her home was in the Hurricane Katrina disaster area and she sustained an economic loss as a result of the Hurricane.*
- *At her request, the plan sponsor suspends her loan repayments for the period beginning December 1, 2005 through December 31, 2006 (a 13-month suspension period).*
- *Wilma's loan repayments resume on January 1, 2007, with the monthly amount increased to \$423, to reflect the interest accrued during the suspension period.*
- *The loan pay-off date is now April 30, 2011.*

Other methods of applying the KETRA suspension provision, to take advantage of the full one-year suspension periods allowed, are also possible.

## Plan Amendments

Sponsors of qualified plans, ERISA 403(b) plans, and governmental section 457(b) plans that want to offer KETRA distributions or plan loans or temporarily suspend loan repayments will need to amend their plans to reflect these provisions. In general, that amendment deadline will not be earlier than the last day of the first plan year beginning on or after January 1, 2007. For governmental plans, the amendment deadline will not be earlier than the last day of the first plan year beginning on or after January 1, 2009. In [Notice 2005-95](#), the IRS indicates that sponsors of qualified plans will likely have to adopt special amendments to reflect these provisions before they adopt their EGTRRA plan restatements. However, the IRS has not yet decided whether to provide sample amendments. If Prudential provides document services for your plan, we will

work with you to draft the appropriate amendments to reflect these provisions by the appropriate amendment deadline.

## Next Steps

If you wish to offer KETRA distributions, loans, or loan repayment suspensions under your retirement plan or program, or if you wish to accept recontributions of KETRA distributions under your plan or program, please contact your Prudential Retirement representative before you authorize any such transactions. To ensure that the appropriate tax reporting occurs, we need to be able to identify these transactions in advance. In addition, we have developed new forms to aid in the processing of these transactions.



## Compliance Clips

### New Law Extends KETRA Relief to Victims of Hurricanes Rita and Wilma

On December 21, 2005, President Bush signed into law the Gulf Opportunity Zone Act of 2005 (GOZA). This new law extends the KETRA distribution and plan loan relief to individuals located in the federally-declared Hurricane Rita and Hurricane Wilma disaster areas.

As a result, a qualifying individual is eligible to take a “qualified hurricane distribution” from a profit sharing plan (including a section 401(k) plan), money purchase pension plan, stock bonus plan, defined benefit plan, 403(b) arrangement, governmental section 457(b) plan, or traditional IRA, subject to the \$100,000 limit that applies to KETRA distributions. These distributions are eligible for the same special tax treatment as KETRA distributions. They are automatically included pro-rata in the individual’s income over a three-year period and may be recontributed to an eligible retirement plan within three years of distribution.

In addition, the maximum loan amount for individuals affected by Rita or Wilma is increased to the lesser of \$100,000, or 100% of the participant’s vested account balance, for loans taken during the specified time periods. Plan loan repayments due from victims of Hurricanes Rita or Wilma on or after December 21, 2005, and before January 1, 2007, may also be suspended for up to one year.

Finally, hardship distributions taken after February 28, 2005, but before the arrival of these hurricanes, to purchase or construct a principal residence in the applicable Hurricane area may be recontributed to a retirement plan in which the individual is participating before March 1, 2006.

An upcoming issue of the *Pension Analyst* will provide detailed information about the GOZA provisions.

#### **Pension Analyst by Prudential Retirement**

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