

Publications

IRS Adopts Revamped Minimum Required Distribution Rules

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SERVICES

The Internal Revenue Service recently issued a comprehensive set of (mostly) final regulations under Code Section 401(a)(9) (the “2002 regulations”) for the calculation of minimum required distributions (“MRDs”) from qualified plans, IRAs, and tax-deferred annuities under Code Section 403(b) (“TDAs”). 67 Fed. Reg. 18988 (Apr. 17, 2002). These regulations simplify the calculation of MRDs for defined contribution plans, IRAs, TDAs, and 457(b) plans consistent with the approach reflected in proposed regulations issued in January 2001 (the “2001 proposed regulations”) and will reduce MRD amounts in the vast majority of cases. The 2001 proposed regulations have been modified to address many issues raised in comments, and to include a new mortality table mandated by last year’s tax legislation. They also implement limited IRA reporting rules as of January 2003 applicable to IRA owners. The final regulations cover all areas of MRDs, except for defined benefit plans and annuity contracts, where the rules are published in temporary and proposed form to allow further comment (by July 16).

The 2002 regulations are effective (and must be followed) for MRDs made for calendar years beginning on and after January 1, 2003. Thus, starting in 2003, the MRDs for all participants and beneficiaries — including persons already receiving payments — will have to be calculated under the 2002 regulations. However, for 2002 MRDs (including initial MRDs made by April 1, 2003 for persons who attain age 70½ in 2002), taxpayers may rely on the MRD regulations proposed in 1987 (the “1987 proposed regulations”), the 2001 proposed regulations (if one of the IRS’ model amendments is adopted), or the 2002 regulations.

The IRS intends to release guidance in the near future on how (and when) to reflect the final MRD regulations in plan documents. We understand the IRS is considering a model amendment approach similar to that used to implement the 2001 proposed regulations. IRA documents must be updated in accordance with Rev. Proc. 2002-10.

Our detailed summary of the 2002 regulations supplementing the highlights in Qualified Plans 2002-4, follows.

“A. Major Changes to the MRD Rules

The 2002 regulations adopt the dramatic simplification of the determination of MRDs from defined contribution plans proposed in 2001, and make major revisions to the rules governing the determination of MRD annuity payments under defined benefit plans. The old and new provisions for each broad category of plan are compared in the attached side-by-side.”

“B. Changes to the IRA, TDA and Eligible 457 Plan MRD Rules

The final IRA and TDA regulations generally conform to the 2001 proposed regulations with the following exceptions.

IRA Reporting — The requirement in the 2001 proposed regulations that, starting in 2004, IRA trustees, custodians, and issuers calculate and report MRDs to the IRS has been eliminated. Instead, new reporting rules primarily directed to IRA owners are adopted. The 2002 regulations themselves simply provide that the IRS may issue guidance requiring the reporting of MRD-related information to the IRS, IRA owners, and other individuals. Notice 2002-27 (May 6 IRS Bulletin) announces the following reporting requirements:”

Beginning with the 2004 calendar year, IRA trustees, custodians, and issuers must report to IRS each IRA for which a MRD is required to be made to an IRA owner on the Form 5498 for the immediately preceding year (e.g., the 2003 Form 5498 will indicate if an MRD is required for 2004). However, there is no requirement that the amount of MRD be reported on Form 5498.

Beginning with 2003 MRDs, by January 31 of that year, IRA trustees, custodians, and issuers must either (A) automatically provide an IRA owner (as defined in the 2002 regulations) with a statement of the amount of the MRD required for that year, or (B) provide an IRA owner with a statement that a MRD is required for the calendar year (including the date by which the MRD must be distributed) and offer to calculate the MRD from that IRA at the owner's request. This reporting requirement does not currently apply to IRA beneficiaries, but does apply where a surviving spouse has elected to treat the decedent's IRA as his or her own.

Inherited IRAs — A spouse may elect to be treated as the owner of an inherited IRA (e.g., by redesignating the account) only after the distribution of the MRD amount for the year of the owner's death (calculated as if the IRA owner had survived until the end of calendar year). A spouse's election to be treated as the owner of the IRA may be made at any time after the IRA owner's death. This election is not available unless the spouse is the sole beneficiary of the account and has an unlimited right to withdraw funds from the account (e.g., a trust named as plan beneficiary with a spouse as sole trust beneficiary is not sufficient). Except for the required minimum distribution for the year of the employee's death, the spouse is permitted to roll over the post-death required minimum distributions to his or her IRA. This concept does not apply to TDAs, even though TDAs generally are treated as IRAs for MRD purposes.

Simplification of IRA MRD Calculations — Distributions for an IRA owner's first distribution calendar year (e.g., the calendar year in which he or she attains age 70½) that are made after December 31 need not be taken into account when determining amounts to be distributed for the IRA owner's second distribution calendar year. In addition, amounts received after December 31 of a calendar year are not required to be taken into account in determining the

distribution amount for the next calendar year except that (1) amounts distributed during a calendar year by a distributing IRA but not received by the recipient IRA until the next calendar year must be taken into account as if they were received in the calendar year of distribution, and (2) recharacterized contributions (e.g., failed conversions to Roth IRAs) must be taken into account by the transferee IRA for the year in which the conversion or failed conversion occurred.

Trust-to-Trust IRA Transfers — Because MRDs can be satisfied from any of an individual's IRAs, it is permissible for a transferor IRA to transfer the full IRA balance to a transferee IRA without holding back the MRD payment attributable to the transferor IRA.

Transfer of Pre-1987 Grandfathered TDA Account Balances — A pre-1987 grandfathered account balance will not lose its grandfathered status because of its transfer from one 403(b) contract to another 403(b) contract. However, if a pre-1987 grandfathered account balance is rolled over to an IRA or plan, its grandfathered status will be lost.

TDA Reporting — There are no reporting requirements applicable to TDAs.

TDA Church Retirement Income Accounts — Annuity payments from church retirement income accounts (sec. 403(b)(9)) may satisfy the requirements applicable to MRDs paid under annuities issued by insurance companies.

Eligible Deferred Compensation Plans (457(b) Plans) — According to the Preamble to the recently proposed section 457 regulations, distributions from an eligible deferred compensation plan described in Code section 457(b) are subject to the 2002 regulations as of January 1, 2003. For 2002, plan sponsors may apply the 1987 proposed regulations, the 2001 proposed regulations or the 2002 regulations.

“C. Other Clarifications

The final regulations clarify a number of other issues, including the following.”

Trusts — Where a trust is designated as an individual's beneficiary, the deadline for providing a final list of beneficiaries of the trust has been changed from the end of the calendar year of the employee's date of death (in the 2001 proposed regulations) to October 31 of the year following the calendar year of the employee's death. This list of beneficiaries must be the final list as of September 30 of the calendar year following the calendar year of the participant's death. These trust documentation requirements also apply when a spouse is asserting that he or she is the sole beneficiary of the trust during the individual's lifetime. Under a transition rule, a trust for which documentation was not provided to the plan administrator by October 31 of the calendar year following the calendar year of a participant's death may still qualify for the special trust beneficiary MRD rules provided that the trust's required documentation is provided to the plan administrator by October 31, 2003. This rule allows trusts that were not irrevocable before death or that did not otherwise qualify for the trust beneficiary MRD rule under the 1987 proposed regulations (prior to their amendment in 1997) to take advantage of the “look through” rule to treat trust beneficiaries as designated beneficiaries for MRD purposes.

Excise Tax (Code Section 4974) — The following changes relate to the 50% excise tax in Code section 4974:

The automatic waiver from the 50% tax is retained for an individual payee who is the sole beneficiary and whose MRD payment is determined using the life expectancy method rule, where the employee dies before benefits start and the entire benefit is distributed to the beneficiary within the 5-year period added by the 2001 proposed regulations.

The excise tax regulations are revised to reference the MRD rules applicable to both Roth IRAs and 457(b) plans.

A special calculation rule is added for plans that provide that a participant's required beginning date is April 1 of the calendar year following the calendar year in which the participant attains age 70½. Under this rule, if payments are to be made under an annuity payment form that does not satisfy the MRD rules (i.e., an impermissible annuity distribution option), the applicable MRD for each

year will be the lesser of the MRD calculated based on the age 70_ required beginning date in the plan and the later of age 70_ or the required beginning date permitted under the MRD rules.

Anti-Cutback Rule Exception — Elimination of an optional form of benefit that violates Code section 401(a)(9) will not result in the failure of the plan to comply with Code section 411(d)(6).

EPCRS — The 2002 regulations remove the special rule relieving a plan from disqualification for isolated failures to satisfy Code Section 401(a)(9) because all such failures for qualified plans and TDAs are now permitted to be corrected through EPCRS. Although not currently available to 457(b) plans, recent guidance from the Service indicates that EPCRS (or a similar process) will soon be available to 457(b) plans as well.

Distributions That Count Toward the MRD — All distributions other than certain listed distributions (generally corrective distributions and certain rollovers and trust-to-trust transfers) are taken into account under the MRD rules. Amounts treated as recovery of “basis” from an insurance contract or as net unrealized appreciation on employer securities (e.g., on securities purchased with employee contributions), even though not includible in income, count toward MRD payments.