



**FOR IMMEDIATE ACTION**

**Distributions and Withdrawals**

**November 2002\***

## **IRS Publishes Additional Rules for Required Payments From Defined Benefit Plans**

**WHO'S AFFECTED** This information applies to sponsors of qualified defined benefit plans, including governmental plans and non-electing church plans.

**BACKGROUND AND SUMMARY** All qualified plans must begin making payments, called Minimum Required Distributions (MRDs), by a participant's required beginning date (RBD). Most defined benefit plans begin making pension payments at a participant's RBD, rather than making just an MRD payment. However, MRD rules do apply and may be most notable when an employee earns additional benefits after reaching his RBD.

These payment rules were complicated when the Small Business Job Protection Act of 1996 (SBJPA) changed the definition of RBD. As a result, different groups of participants have different RBDs.

In addition, in 2001, the IRS published proposed changes to the MRD rules. Plan sponsors did not have to adopt these rules, but if they did so, the changes generally did not affect defined benefit plan participants. In 2002, the IRS published additional revised MRD rules. For the most part, these rules followed the 2001 rules but they did contain some changes to the defined benefit plans that have become controversial. While the regulations indicate that plan sponsors must follow these rules beginning with distributions made in 2003, IRS officials have recently informally indicated that defined benefit plan sponsors will be allowed to continue to use either the 1987 rules or the 2001 rules until further notice.

**ACTION AND NEXT STEPS** Participants who are 5% owners and reach age 70½ in 2002 will need to receive their first MRDs by April 1, 2003. Participants who are 5% owners and reached age 70½ before January 1, 2002, will need to receive their 2002 MRDs (plus required actuarial increases, if they earned additional benefits in 2002) by December 31, 2002. Participants who reached age 70½ in 2002 or earlier and are *not* 5% owners, including participants in governmental plans and certain church plans, may also need to receive MRDs for 2002.

For all distributions that must be made by December 31, 2002, we must receive the appropriate forms no later than *November 20, 2002*. For payments that must be made by April 1, 2003, we must receive the appropriate forms no later than *February 3, 2003*. If we receive forms after these dates, we will make our best efforts, but cannot guarantee, to make distributions in a timely manner.

\*Republished December 2004 to reflect Prudential Financial's acquisition of CIGNA's retirement business.

In addition, plan sponsors should familiarize themselves with the 2002 MRD rules. Any plan sponsor that wants to put these rules into effect for 2003 will have to adopt the appropriate plan amendment by the last day of the first plan year beginning on or after January 1, 2003. As always, amendment decisions should only be made after consulting the plan's enrolled actuary.

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### **Basic MRD Rules for Defined Benefit Plans**

An employee must begin receiving his pension benefits once he reaches his Required Beginning Date (RBD). Usually, these benefits are paid in the form of an annuity. To satisfy the minimum required distribution (MRD) rules, the annuity must be paid periodically. Payment intervals cannot be more than one year in length, but may be shorter. Most plans make monthly payments.

Under the MRD rules, payments must be made

- Over the life (or lives) of the participant (and his designated beneficiary); or
- Over a period certain that is not longer than the life expectancy (or joint and last survivor expectancy) of the participant (and his designated beneficiary).

A single life annuity (which pays benefit for the life of the participant) and a joint and survivor annuity with the participant's spouse designated as the beneficiary automatically satisfy these rules.

Other types of annuity payments may be made. For example, payments may be made under a joint and survivor annuity (or "contingent beneficiary annuity") where the designated beneficiary is not the participant's spouse. Annuities may also be paid for a guaranteed minimum payment period (e.g., a "10-year certain and life annuity"), or may be paid for *only* a guaranteed payment period (e.g., a "10-year certain annuity").

Special rules apply to specific types of annuity payments. For example, once payments begin over a period certain, the period certain may not be changed. Also, if the survivor of a joint and survivor annuity is not the participant's spouse and is more than 10 years younger than the participant, the survivor benefit must be less than 100% of the participant's benefit.

If an employee begins to receive his pension benefits under the MRD rules while he is still employed, he will usually earn additional benefits while he remains employed. Each calendar year's additional accrued benefits must begin to be distributed in the first benefit payment made during the next calendar year.

If a participant who has reached his RBD takes a single sum cash settlement of his benefits, the MRD portion of the payment (which cannot be rolled over to another qualified plan or Individual Retirement Account) is typically determined using the rules that apply to defined contribution plans.

The MRD rules also specify the manner in which death benefits must be paid. When a participant dies after he has reached his RBD and benefit payments have begun, the remaining benefits must be paid out at least as rapidly as they were being paid to the participant. Annuity payments generally meet these rules. When a participant dies before reaching his RBD, payments must be made according to either the five-year cash-out rule or the life expectancy rule. The standard Qualified Preretirement Spouse Annuity (QPSA) that is paid by most qualified defined benefit plans automatically meets these death payment requirements.

### **SBJPA Changes to the MRD Rules**

The Small Business Job Protection Act of 1996 (SBJPA) changed the MRD Required Beginning Date. Different groups of participants have different RBDs.

- The RBD for a participant who is a *5% owner* of his employer is the April 1 following the calendar year in which the participant reaches age 70½, even if he is still employed.
- In general, the RBD for a participant who is *not a 5% owner* is the April 1 following the later of the calendar year in which he reaches age 70½ or the calendar year in which he retires.
- The RBD for any participant in a *governmental plan* or a *church plan* is the April 1 following the later of the calendar year in which he reaches age 70½ or the calendar year in which he retires.

Special exceptions to these standard RBDs may apply to certain groups of participants.

### **5% Owners**

If an employer is a corporation, a “5% owner” is any employee who owns (or is considered to own under family attribution rules) *more than 5%* of the value of the corporation’s outstanding stock or stock having *more than 5%* of the total combined voting power of all of the corporation’s stock. If an employer is not a corporation, a 5% owner is any employee who owns more than 5% of the capital or profits interest in the employer.

In general, employees who are 5% owners must start receiving benefits from the plan no later than the April 1 following the calendar year in which they reach age 70.

### **Non-5% Owners**

Under the Small Business Job Protection Act of 1996 (SBJPA), employees who are not 5% owners (“non-5% owners”) must begin receiving benefits by the later of:

- April 1 following the calendar year in which they leave employment, or
- April 1 following the calendar year in which they reach age 70½.

However, this SBJPA RBD affects participants differently according to their dates of birth and the way the plan is amended to comply with the SBJPA rules.

### **Plan Amendment Options**

Plans had the following options for complying with the SBJPA RBD changes:

- Adopt the new RBD rules for non-5% owners who reach age 70½ after December 31, 2002, or, if later, in calendar years beginning after the amendment adoption date.
- Adopt the new RBD rules, as discussed above, but permit active employees who are non-5% owners to elect to begin receiving payments at any time on or after the April 1 following the calendar year they reach age 70½.
- Adopt the new RBD rules, but only with respect to benefits that have not accrued as of the later of the plan amendment adoption date or effective date. This option is not particularly attractive, due the administrative complexity it creates. However, this type of amendment may be made at any time, even after the plan's SBJPA amendment deadline.
- Keep the old RBD rules. Under these rules, all participants (both 5% owners and non-5% owners) must begin receiving payments by the April 1 following the calendar year they reach age 70½.

### **Special Rules**

Some participants may have signed an election form before January 1, 1984, to remain under the *distribution rules in effect before the enactment of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)*. If such an election was made, the employee must receive payments according to that election. A change in beneficiary does not revoke this election, unless it changes the period over which payments will be made.

The RBD for a *non-5% owner who was born before July 1, 1917 (i.e., reached age 70½ before January 1, 1988)* is the April 1 following the later of the calendar year in which he reaches age 70½ or the calendar year in which he retires.

*A non-5% owner who was born between July 1, 1931, and June 30, 1932 (i.e., reached age 70½ in 2002), and is still employed may be allowed to defer his payment beginning date to his SBJPA RBD.* This option may only be offered under a plan that has not yet been amended to reflect the SBJPA rules. Elections to defer these payments must be made by April 1, 2003.

The RBD for any participant in a *governmental plan or certain church plans* has always been the April 1 following the later of the calendar year in which the participant reaches age 70½ or the calendar year in which he retires.

## New MRD Regulations

In January 2001, the IRS published proposed changes to the MRD rules, which were discussed in our March 2001 *Pension Analyst* titled “[IRS Issues New Minimum Required Distribution Regulations.](#)” For the most part, these changes did not affect defined benefit plan participants to whom Prudential Retirement makes payments, since these participants are treated as if they retired on their RBDs, even if they are still employed. However, some plan sponsors may have chosen to amend their plans to reflect these rules effective in either 2001 or 2002.

In April 2002, the IRS published proposed and temporary MRD rules for defined benefit plans, which generally follow the 2001 proposed rules but make some additional changes. These changes do not affect the definition of RBD, but do include the following:

- As required by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), mortality tables have been updated, which may result in longer guaranteed minimum payment periods.
- The application of the rule that requires a survivor benefit to be less than 100% of the participant’s benefit is clarified in the case of joint and survivor annuities that contain a guaranteed minimum payment period. In these situations, the reduction in the survivor annuity does not have to take effect until after the guaranteed payment period ends.
- Plans are allowed to increase annuity payments to reflect cost-of-living adjustments based on the increase in the cost-of-living index that is based on prices of all items and issued by the Bureau of Labor Statistics.
- Whether an employee is considered a 5% owner is to be determined based on the employee’s ownership in the year he reaches age 70-1/2.
- The default rules for determining pre-RBD death payment timing are changed for non-spouse beneficiaries. If the participant’s sole designated beneficiary is his spouse, payments must begin by the December 31 following the later of the year of the participant’s death or the year the participant would have reached age 70-1/2. Since standard QPSA provisions require payments to begin in the first year the participant would have been eligible to retire early, this MRD death payment rule is also met. If the participant’s surviving spouse is not his sole designated beneficiary, payments must begin by December 31 of the year following the participant’s death. If the participant does not have a designated beneficiary and a death benefit is payable, the entire benefit must be paid out by December 31 of the calendar year containing the fifth anniversary of the participant’s death.
- Designated beneficiaries must be determined by September 30 of the calendar year following the year of the participant’s death.

These temporary rules also contain a provision that would not permit plans to calculate MRDs for participants who take single sum distributions using the defined contribution plan rules, except for determining the amount of benefit that is eligible for rollover. This was a very controversial

proposal that has met with a lot of criticism.

As a result of the controversy created by these temporary and proposed rules, IRS officials have recently indicated informally that defined benefit plan sponsors will *not* be required to operate their plans in accordance with these rules beginning January 1, 2003. Instead, plans may continue to follow the 1987 rules, the 2001 rules, or may use these 2002 rules. Plan sponsors that want to follow either the 2001 rules or the 2002 rules for 2003, will have to adopt appropriate plan amendments.

As always, plan sponsors should consult the plan's enrolled actuary before taking any amendment action.

Plan sponsors may find that the most prudent course of action is to maintain the status quo and continue to follow the 1987 regulations until the IRS provides additional guidance.

### **MRD Payment Deadlines**

Any participant who previously received an MRD must receive another MRD by December 31, 2002, unless he has received distribution(s) during 2002 that satisfy the MRD requirements. The amount of the MRD must reflect any additional benefits earned in 2002. If we regularly calculate benefits for your plan, we will calculate the additional payments due, which will be paid by December 31, 2002 to employees who took their MRDs as single sum cash settlements. Otherwise, these additional benefits will be reflected in retirement income payments made beginning January 1, 2003. If we do not calculate your plan's benefits, you must provide us with any increased payment amounts by November 20, 2002. There is no need to complete new Defined Benefit Payment Authorization forms for these employees.

The following participants must receive MRD payments for 2002 by April 1, 2003:

- 5% owners who reached age 70½ (i.e., born between July 1, 1931 and June 30, 1932) in 2002, even if still employed.
- Non-5% owners who reached age 70½ in 2002 and leave employment in 2002.
- Non-5% owners who previously suspended or deferred required payments, as permitted by IRS rules and plan provisions, and leave employment in 2002.
- Participants in governmental plans and certain church plans who reached age 70½ in 2002 or earlier and leave employment in 2002.

As previously discussed, specific plan provisions may require other groups of participants to receive payments by December 31, 2002, or April 1, 2003, or may provide other groups of participants with the option to begin taking payments.

If a plan continues to apply the pre-SBJPA MRD rules in 2002, because it has not yet been amended to reflect the new rules, plan sponsors may allow an employee to defer his payment beginning date to his new SBJPA required beginning date.

**Pension Analyst by Prudential Retirement**

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