

# Pension ANALYST



Important Information

Distributions and Withdrawals

December 1997\*

## IRS Provides Additional Guidance On New Minimum Payment Rules

**WHO'S AFFECTED** This information applies to sponsors of defined benefit and defined contribution plans, including tax-sheltered annuity programs. It does not apply to governmental plans or church plans.

**BACKGROUND AND SUMMARY** The Small Business Job Protection Act of 1996 (SBJPA) made significant changes to the rules regarding qualified plan and tax-sheltered annuity program minimum required distributions (MRDs). These changes took effect on January 1, 1997. During 1997, the IRS published a series of Notices and Announcements to give plan administrators guidance in applying these new rules. On October 28, 1997, the IRS held a public hearing to identify open issues regarding the minimum payment rules and solicit public input regarding possible approaches for dealing with those issues. As a result of this hearing, the IRS has published Notice 97-75, providing guidance on several of these issues.

Most importantly, this Notice provides the rules for allowing employees who are already receiving payments under the pre-SBJPA MRD rules to suspend those payments and discusses the interaction of these suspension rules with spousal consent requirements. It also clarifies the taxability of payments being made under the pre-SBJPA rules that are no longer legally required payments. For defined benefit plans, the Notice provides guidance regarding the actuarial increase that is now required for non-5% owners and its interaction with the actuarial increase required under the basic suspension of benefits rules.

**ACTION AND NEXT STEPS** You will need to review the new plan design options that are now available and, in particular, decide whether you want to permit non-5% owners who are already receiving payments under the pre-SBJPA MRD rules to suspend those payments.

**AS WE GO TO PRESS** On December 30, 1997, the IRS published proposed changes to the Minimum Required Distribution (MRD) rules. These changes provide additional guidance for naming a trust as a participant's beneficiary for MRD purposes. We will provide additional information on these proposed rules as it becomes available.

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

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## **IRS Provides Additional Guidance on New Minimum Payment Rules**

As 1997 comes to a close, the IRS is trying to tie up some of the loose ends remaining regarding the application of the minimum required distribution (MRD) rules as revised by the Small Business Job Protection Act of 1996 (SBJPA). IRS Notice 97-75 specifically addresses several important issues that remained open even after the publication of earlier IRS guidance.

### **Required Beginning Date for Active Non-5% Owners**

The required beginning date (RBD) for any non-5% owner who reached age 70½ before January 1, 1997 (i.e., was born before July 1, 1926), and did not retire before January 1, 1997, is determined under the SBJPA rules. That is, the law does not require the plan to begin making payments until April 1 of the calendar year following the year the employee actually retires.

For example, a non-5% owner who reached age 70½ in 1995, and retired in 1997, would not have to begin receiving payments until April 1, 1998.

However, because plan documents contain the pre-SBJPA MRD rules, a plan sponsor may be required to apply those rules until it amends its plan document to reflect the new MRD rules. In addition, plan sponsors may choose to apply the old rules in certain situations. In both instances, payments made under the old MRD rules but before required under the SBJPA MRD rules are not treated as true MRDs.

### **Use of Pre-SBJPA MRD Rules**

A plan may continue to apply the pre-SBJPA MRD rules and require payments to begin by April 1 of the calendar year following the year an employee reaches age 70½, whether or not the employee is a 5% owner. The old rules may be applied to all employees or the plan sponsor may amend the plan to apply the old rules only to a specific group of employees (for example, to non-5% owners who reach age 70½ before January 1, 1999).

If a plan continues to apply the old MRD rules, both the employee's beneficiary and his election to recalculate (or not) his life expectancy must be determined based on any elections in effect as of the April 1 of the calendar year following the year he reaches age 70½. The employee cannot change these elections when he reaches his SBJPA RBD. If an employee dies after payments have begun under the old rules, his remaining benefits must be paid at least as rapidly as they were

being paid while the employee was alive (that is, he will be treated as dying after "true" MRD payments have begun).

Payments made after an employee's old RBD but before his SBJPA RBD are not treated as MRD payments for tax purposes. These payments may be considered eligible rollover distributions, subject to 20% Federal withholding if they are not directly rolled over. However, in most cases these payments will not be eligible for rollover under other exceptions to the rollover rules, as discussed later in this *Pension Analyst*.

### **Suspension of Payments Begun Before January 1, 1998**

A plan sponsor cannot simply suspend payments that are currently being made under the pre-SBJPA MRD rules to non-5% owners who reached age 70½ before January 1, 1997, and are still employed. However, a plan may give these employees the option to suspend their payments at any time before their actual retirement dates. Generally, an election to stop these payments is subject to the spousal consent rules as they apply to the plan and the participant. However, if certain requirements are met, additional spousal consent may not be needed.

If the plan does *not* treat the employee's SBJPA RBD as a new annuity starting date, no spousal consent will be needed for the employee to stop receiving his original payments. In addition, no spousal consent will be needed when the payments begin again after the employee's termination of employment if all of the following requirements are met:

- SBJPA MRD payments are made in the same form as the original MRD payments, with the same designated beneficiary;
- If the employee is still married as of his new RBD to the person who was his spouse when payments originally began, that spouse originally gave general consent to payments made in a form other than the qualified joint and survivor form of annuity or with a non-spouse designated beneficiary. "General consent" means that the spouse did not consent to either a specific form of payment or a specific non-spouse beneficiary; and
- If the employee is no longer married to the person who was his spouse when payments originally began, the original spouse gave specific consent to payments made in a form other than the qualified joint and survivor form and, if applicable, to a non-spouse beneficiary.

If the plan *does* treat the employee's SBJPA RBD as a new annuity starting date, no spousal consent will be needed for the employee to stop receiving his original payments, unless those payments are being made as a qualified joint and survivor annuity. If the employee is receiving qualified joint and survivor annuity payments, the person who was his spouse on his original RBD must consent to the election to suspend payments. That consent must acknowledge the financial effect of this election. When the employee reaches his new RBD, following retirement, all the standard spousal notice and consent requirements apply again. If the employee dies before reaching his SBJPA MRD, a qualified preretirement spouse annuity must be paid.

In both of these situations, the plan sponsor must comply with these rules in operation and amend the plan by its SBJPA amendment deadline to reflect that plan operation. In addition, the employees who want to suspend their payments must stop them before the SBJPA amendment deadline.

Spousal consent to stop or resume the payments is not needed if the participant is not subject to the spousal consent rules. A participant in a profit sharing plan (including a 401(k) plan) is not subject to the spousal consent rules if his spouse is the beneficiary of his entire account balance, his

account does not include assets transferred from a plan that is subject to the spousal consent rules, and he has never received benefits from the plan in the form of life annuity payments.

### **Tax Treatment of Ongoing Pre-SBJPA MRDs**

If an actively employed non-5% owner continues to receive payments under the pre-SBJPA rules before he retires, those payments will not be treated as MRD payments. In some situations, those payments will be treated as eligible rollover distributions and will be subject to 20% Federal withholding if they are not directly rolled over.

However, if these payments are part of a series of substantially equal periodic payments made over:

- The life (or life expectancy) of the employee;
- The joint lives (or life expectancies) of the employee and his designated beneficiary; or
- A specified period of 10 years or more,

they will not be eligible rollover distributions. Annuity payments and installment payments made over a specified period of at least 10 years are examples of this type of payment.

Annual payments made from defined contribution plans are considered to be "substantially equal periodic payments." Therefore, these payments are *not* eligible rollover distributions.

Some actively employed non-5% owners who reached age 70½ in 1996, received payments from their defined contribution plans in 1997 under the old MRD rules. Most of these payments were made before the IRS published Notice 97-75, clarifying this tax treatment. In January 1998, we will notify employees who received these payments that they were not eligible rollover distributions and provide instructions for correcting any rollovers that these employees may have made.

### **Actuarial Increase Rules for Defined Benefit Plan Payments**

Under SBJPA, a defined benefit plan must actuarially increase benefits paid to a non-5% owner when he retires after reaching age 70½. In Notice 97-75, the IRS clarifies that this increase must be provided for the period beginning on the April 1 following the calendar year in which the employee reached age 70½ and ending on the date that payments begin following the employee's retirement. However, if the employee reached age 70½ before January 1, 1996, this increase period begins on January 1, 1997. The actuarial increase requirement does not apply if the plan continues to apply the pre-SBJPA MRD rules.

This increase must be calculated using the plan's assumptions for determining actuarial equivalence and must be applied to both the benefits earned as of the April 1 following the calendar year the employee reached age 70½ (or January 1, 1997, if applicable) and additional benefits earned after that date. The increase must be reduced by the value of any distributions made after that April 1 and before the employee's retirement date.

The increase required under the SBJPA MRD rules is generally the same as the increase required under the suspension of benefit rules for postponed retirees. It is *not* an additional increase, except that it must be provided for some periods that are not subject to the suspension of benefits increase. Thus, this increase may reduce the additional benefit accrual that may otherwise be required.

## Open Issues

Notice 97-75 still does not address two very important issues. While this Notice does provide a special rule to coordinate the SBJPA MRD amendments with the rule that all payment options generally be available to all plan participants, the IRS has still not provided guidance for eliminating the old MRD rules without violating the protected benefit rules. In addition, the IRS has not yet defined the term "retirement date," especially in controlled group situations where an employee could "retire" from employment with one member of the controlled group and then go to work for another group member.

## Next Steps

You should review the plan design options that are now available to you with respect to MRD payments. If you want to permit non-5% owners who reached age 70½ before January 1, 1997, to suspend payments that began under the old MRD rules, you should review your plan document to determine if these participants' spouses will need to consent to these suspensions.

Remember that the deadline for making SBJPA plan amendments is currently the last day of the 1999 plan year. You will need to keep careful records of this and any other MRD-related options that you offer employees (for example, if you let non-5% owners who reached age 70½ in 1996 defer their payment starting dates to their SBJPA RBDs), so they can be correctly reflected in your SBJPA amendment. You may also need to otherwise formalize the design decisions that you make (for example, via a Board of Directors' resolution).

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

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