

IRS Issues Final Minimum Required Distribution

WHO'S AFFECTED These rules apply to qualified defined contribution plans (including 401(k) plans, governmental plans, and nonelecting church plans) and 403(b) programs.

BACKGROUND AND SUMMARY Earlier this year the IRS issued final minimum required distribution (MRD) regulations. The final rules adopt the proposed rules issued in early 2001, with some additional changes that further simplify and clarify the rules. In general, these rules should make it easier for plan administrators and participants to comply with the MRD requirements.

The changes include the following:

- As required by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the final rules include updated mortality tables, which should generally result in smaller MRD payments lasting for a longer period of time.
- To provide adequate time to calculate and distribute an MRD payment after a participant's death, the designated beneficiary(ies) must be determined by September 30 of the calendar year following the calendar year of the participant's death.
- The marital status of a participant is determined as of January 1 of the distribution calendar year.
- Contributions and payments made after December 31 of a calendar year will generally be disregarded when determining the MRD amount for the next calendar year.
- The standard payment method for distributions made when a participant dies before reaching his required beginning date (RBD) is the life-expectancy method. The final rules provide a transition period for beneficiaries who may have previously fallen under the five-year rule.
- A participant is classified as a 5% owner based on his ownership in the calendar year in which he turns age 70-1/2. Ownership in the preceding and succeeding calendar years is disregarded.
- Specific requirements must be met in order for a Trust to be a valid beneficiary under the MRD rules.
- The 50% penalty tax for late MRD payments is automatically waived if certain requirements are met.

The IRS issued additional proposed rules for MRD payments for defined benefit plans and annuity contracts providing benefits under qualified plans, and section 403(b) programs. These regulations will be addressed in a separate *Pension Analyst*®.

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

ACTION AND NEXT STEPS These regulations apply for determining MRDs for calendar years beginning on or after January 1, 2003. Plan sponsors must adopt a model amendment by the last day of the first plan year beginning on or after January 1, 2003, to comply with the final MRD rules.

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The final MRD regulations generally incorporate the 2001 proposed rules with some modifications and clarifications. These changes provide plan sponsors with simplified rules for providing distributions to affected participants and beneficiaries.

Rules That Have Not Changed

The final rules do not make any changes to the following special MRD definitions:

- **Required Beginning Date (RBD).** The RBD for a participant who is a *5% owner* of his employer is the April 1 following the calendar year in which he reached age 70-1/2, even if he is still employed. 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 70-1/2 or the calendar year in which he retires. The RBD for any participant in a *governmental plan* or *nonelecting church plan* is the April 1 following the later of the calendar year in which he reaches age 70-1/2 or the calendar year in which he retires. Special exceptions to these standard RBDs may apply to certain groups of participants.
- **Distribution Calendar Year.** A “distribution calendar year” is the calendar year for which an MRD payment is required.
- **Valuation Date.** The “valuation date” is December 31 of the calendar year preceding the distribution calendar year .

Changes to the Mortality Tables

As required under EGTRRA, the IRS has updated the mortality tables that are used to calculate MRDs paid during a participant's lifetime and after his death. The Uniform Lifetime Table is used to calculate MRDs during the participant's lifetime, unless the participant has a spouse more

than 10 years younger as his sole beneficiary. The Joint and Last Survivor Table is used if a participant has a spouse more than 10 years younger as his sole beneficiary. The Single Life Table is used to calculate MRDs after the death of the participant.

Account Balance Used to Determine MRDs

The account balance used to determine the amount of an MRD no longer needs to include contributions and forfeitures accrued but not yet allocated as the valuation date.

If a participant's MRD for the first distribution calendar year is paid during the grace period (January 1 through March 31 of the year following the calendar year in which the participant turned age 70-1/2), the amount of that MRD is no longer deducted from the account balance used to determine the MRD for the second distribution calendar year.

For example, Joseph's required beginning date (RBD) is April 1, 2003, and his December 31, 2002, account balance is \$350,000. On February 1, 2003, Joseph receives his 2002 MRD for \$12,774. For purposes of determining his 2003 MRD, the account balance used is \$350,000, not \$337,226 (\$350,000 - \$12,774).

When to Determine 5% Ownership

The law requires 5% owners to begin taking MRDs by April 1 of the calendar year following the calendar year in which they turn age 70-1/2. The final rules clarify that ownership is determined in the calendar year in which the participant turned age 70-1/2, regardless of ownership in the preceding or succeeding calendar years.

For example, Mark is actively employed and turned age 70-1/2 in 2002. He was a 5% owner from 1985 - 2001. He sold his ownership in 2001. Therefore, for MRD purposes, he is not considered a 5% owner and would not have to begin taking MRDs until he retires from employment.

It is important to note that the final rules still do not define the term "retirement."

Marital Status Determination

A participant's marital status is determined on January 1 of each calendar year. If a participant is married on January 1, but does not remain married for the entire calendar year, the MRD for that year is determined as if the participant were still married. However, for distributions in later years, the factor must be adjusted to reflect the change in marital status. Generally, this rule will only affect:

- A participant whose spouse is his sole beneficiary and is more than 10 years younger than the participant; and
- A participant who began the year unmarried, but married during the year and named as his sole beneficiary his spouse who is more than 10 years younger.

Designation of Beneficiaries

To provide enough time to calculate and distribute an MRD after the death of a participant, the participant's designated beneficiary must be determined by September 30 of the calendar year following the calendar year of death.

The regulations clarify that in order for a beneficiary to disclaim a benefit, the disclaimer must satisfy certain requirements, including Internal Revenue Code section 2518. A [sample disclaimer form](#) is included with this publication.

The beneficiary making the disclaimer must not have accepted the benefit before making the disclaimer. The beneficiary may disclaim any interest, in whole or part. However, the disclaimer is irrevocable once it is made.

The disclaimer must be made and delivered to the plan administrator within nine months of the later of the participant's date of death or the date on which the person disclaiming the benefit reaches age 21. Note that this deadline may occur well before the MRD deadline, described above, for identifying a participant's designated beneficiary.

The [sample disclaimer form](#) meets the Code section 2518 requirements, but may or may not meet all the requirements of applicable state law. Beneficiaries who are considering disclaiming benefits should seek legal advice to ensure that all of the appropriate state's requirements have been met.

The regulations also clarify that if a designated beneficiary dies after the participant's death has occurred and before September 30 of the calendar year following the year the participant died, that individual continues to be treated as a designated beneficiary for MRD purposes.

Default Rule for Pre-RBD Death Payments

In the absence of a plan provision or election of the five-year rule, the final rules provide the default for pre-RBD death payments to be the life expectancy rule. When a participant dies before his RBD, his beneficiaries will receive the payment of benefits based on their life expectancies, unless the plan provides otherwise.

The regulations provide a transition period for beneficiaries who may have previously fallen under the five-year cash-out rule. A beneficiary receiving payments under the five-year rule may switch to the life expectancy rule. The switch may occur provided all amounts that would have been distributed under the life expectancy rule for all distribution years before 2004 are distributed by the earlier of December 31, 2003 or the end of the five-year period.

For example, Lucy died on July 30, 2001, and named her husband Desi and son Desi Jr. to each receive 50% of her account. Under the old MRD rules, the plan provided for the five-year rule. Therefore, Desi Jr. would need to receive his entire portion of the death benefit by December 31, 2006. However, under the final rules, Desi Jr. can begin to receive payments based on his life expectancy in 2003, provided he makes up the missed payment for 2002 by December 31, 2003. The missed payment is not subject to the 50% penalty assessed for late MRD payments.

Trusts as Beneficiary

In order for a trust to be a valid beneficiary for MRD purposes, the following requirements must be met:

- The trust must be a valid trust under state law, or would be but for the fact that there is no corpus;
- The trust must be irrevocable or will, by its terms, become irrevocable upon the death of the participant;
- The beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the participant's benefit must be identifiable within the meaning of a designated beneficiary under the MRD rules;
- Proper documentation must be provided to the plan administrator by October 31 of the calendar year following the calendar year of the participant's death.

If these requirements are met, the beneficiaries of the trust are treated as designated beneficiaries under the plan.

If a trust fails to meet the above requirements solely because the trust documentation was not provided to the plan administrator by October 31 of the calendar year following the calendar year of the participant's death, and such documentation is provided to the plan administrator by October 31, 2003, the beneficiaries of the trust will be treated as the designated beneficiaries of the participant for purposes of determining MRDs.

Automatic Waiver of Excise Tax on Late MRDs

If MRD payments are not made in a timely manner, the IRS imposes a 50% penalty tax on any shortfall. The final regulations adopt the 2001 proposed rules providing for an automatic waiver of any shortfall if the following conditions are met:

- The individual who is receiving payments is the sole beneficiary and is required to receive payments based on his life expectancy and the participant died before his RBD; and
- The entire benefit which the beneficiary is entitled to receive is distributed by the end of the fifth calendar year following the calendar year of the participant's death.

If these requirements are not met, a participant or beneficiary may still apply for a waiver of the penalty tax provided the shortfall was due to reasonable error and reasonable steps have been taken to remedy the shortfall. In the past, the IRS required the person requesting the waiver to pay the excise tax when making the waiver request, with that amount to be refunded if the waiver was granted. It is not clear if the IRS will continue to take this approach under these final rules, since the IRS has not yet released a revised copy of the Form to be used to make this request (Form 5329).

Effective Date and Next Steps

These regulations apply for determining MRDs for calendar years beginning on or after January 1, 2003. Plan sponsors must amend their plans by the last day of the first plan year beginning on or after January 1, 2003, to comply with the requirements of these final MRD regulations.

For determining MRDs for 2002, plan sponsors may follow these regulations, the 2001 proposed rules, or the 1987 proposed regulations. Plans sponsors that applied the final rules to 2002 distributions must identify, in their plan amendment adopting these rules, the date in the 2002 calendar year they chose to begin applying these rules.

If you have any questions about these regulations, or their application to your plan, please contact your Prudential Retirement representative.



COMPLIANCE CLIPS

IRA MRD Reporting Requirements

The IRS published guidance on reports that trustees, custodians and issuers of Individual Retirement Accounts/Annuities (IRAs) must make with respect to MRDs due from IRAs beginning in 2003.

If an IRA owner is due an MRD for a year, the trustee, custodian or issuer must provide a statement to the owner by January 31 of that year regarding the MRD. The trustee, custodian or issuer may provide the IRA owner with either:

- A statement of the amount of the MRD (which may be calculated using the Uniform Lifetime Table) and the date by which it must be taken; or
- A statement that (1) informs the IRA owner that an MRD is required and the date by which it must be taken, and (2) offers to provide, upon request, a calculation of the amount of the MRD.

The trustee, custodian or issuer must also inform the IRA owner that beginning with the 2004 MRD the IRS will be informed that the IRA owner must receive an MRD for the respective calendar year.

No reporting is required for 403(b) programs or for IRAs of deceased owners.