



IRS Publishes Final Rules for Required Payments From Defined Benefit Plans

WHO'S AFFECTED These rules apply to sponsors of and participants in qualified defined benefit plans, including governmental plans and church plans that do not elect to be covered by ERISA ("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.

In 2001, the IRS published proposed changes to the MRD rules that plan sponsors had been following since 1987. These 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 controversial changes to the defined benefit plan rules. Because of this controversy, the IRS did not require defined benefit plans to comply with the 2002 rules. Instead, these plans have been allowed to comply with either the original 1987 rules, the proposed 2001 rules, or the proposed 2002 rules, subject to the adoption of appropriate plan amendments. Most plan sponsors chose to maintain the status quo and continue operating in accordance with the 1987 rules.

The IRS has issued final MRD rules for defined benefit plans, eliminating some of the more controversial provisions contained in the 2002 rules. While these final rules are effective for distributions made in 2003 and later years, plans were allowed to continue to apply the 1987, 2001 or 2002 rules for distributions made in 2003, 2004 and 2005.

ACTION AND NEXT STEPS Plan sponsors should familiarize themselves with these new rules to determine how they will comply with them. They should also assess the impact of these rules on their plan document. IRS officials have recently confirmed that plan sponsors are not required to adopt interim plan amendments reflecting these final rules. However, these final rules will need to be reflected in the restated plan documents that are submitted for the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) determination letters, beginning in 2006. If Prudential Retirement provides document services for your plan, we will amend your plan to incorporate the new rules. However, plan sponsors should not make design changes to their plans without first consulting the plan's enrolled actuary.

IN THIS ISSUE

[Basic MRD Rules for Defined Benefit Plans](#)
[Incidental Benefit Requirement](#)
 [General Rule](#)
 [Payments to a Nonspouse Beneficiary](#)
[Changes in the Form of Payment](#)
[Increasing Annuities](#)
[Segregated Shares](#)
[Payments to Children](#)
[Governmental Plans](#)
 [Distribution Options for Governmental Plans](#)
 [Grandfathered Distribution Options](#)
[Effective Dates](#)
[Next Steps](#)

Basic MRD Rules for Defined Benefit Plans

The basic rules for determining MRD amounts to be paid from a defined benefit plan have not changed.

A participant must begin receiving his pension benefit once he reaches his RBD. 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 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.

Usually, these benefits are paid in the form of an annuity. To satisfy the 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 benefits for the life of a 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").

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. *However*, the final rules permit plans to determine the MRD portion of a single sum cash settlement using either the rules that apply to defined contribution plans or the defined benefit plan rules. In general, the defined contribution rules produce lower MRD amounts, resulting in larger amounts eligible for rollover. If Prudential calculates benefits for your plan, we will continue to apply the defined contribution rules when calculating the MRD for a single sum cash settlement, unless you notify us, in writing, to do otherwise.

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 Pre-retirement Spouse Annuity (QPSA) that is paid by most qualified defined benefit plans automatically meets these death payment requirements. The QPSA requirement does not apply to a governmental plan or a non-electing church plan.

In general, a participant (other than a 5% owner) who retires after the calendar year in which he reaches age 70½, must receive an increased benefit when his benefit payments begin. The plan must actuarially increase his accrued benefit to take into account any period after age 70½ in which he was not receiving any benefits from the plan. The increase must be provided for the period starting on the April 1 following the calendar year in which the participant reaches age 70½, and ending on the date that his benefit payments begin. This actuarial increase requirement does not apply to a governmental plan or a non-electing church plan.

If a participant (typically a 5% owner) 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.

Incidental Benefit Requirement

General Rule

The purpose of the incidental benefit rule is to ensure that annuity payments are made primarily to provide retirement benefits to the participant. If a participant receives payments in the form of a life annuity, the incidental benefit requirement is automatically satisfied. If a participant receives a joint and survivor annuity and his spouse is his beneficiary, the incidental benefit requirement is also automatically satisfied.

Payments to a Nonspouse Beneficiary

The final rules provide a special rule for payments made under a joint and survivor annuity to a nonspouse beneficiary. Under this rule, payments made to the beneficiary cannot exceed a specified percentage of the payments made to the participant. This percentage is based on the number of years that the participant's age exceeds the beneficiary's age and decreases as the

difference between those ages increases. This adjustment reflects the fact that the greater the number of years younger a beneficiary is than the participant, the greater the number of years of payments will be made to the beneficiary following the death of the participant.

However, the final rules permit larger survivor annuities to be paid to a younger nonspouse beneficiary, when the participant is younger than age 70 on his annuity starting date. *For example, if a participant begins to receive his pension payments at age 70 and his nonspouse beneficiary is age 45, the plan may not pay more than a joint and 66% survivor annuity. However, if the same participant begins to receive his pension payments at age 55, when his beneficiary is age 30, the plan may pay a joint and 100% survivor annuity.*

Changes in the Form of Payment

The final rules allow participants and beneficiaries to change the form of future payments in the following circumstances:

- A period certain annuity (i.e., an annuity with no life contingency) may be changed at any time.
- A participant may change to a qualified joint and survivor annuity (QJSA) over the joint lives of the participant and spouse in connection with the participant's marriage.
- Any form of payment may be changed upon actual retirement or plan termination.

In order to change the form of future payments, the following conditions must be satisfied:

- Future payments must satisfy the minimum required distribution rules and the defined benefit annual limitation rules.
- A plan must treat an individual electing a new form of payment as having a new annuity starting date for purposes of defined benefit annual limitation rules, and participant notice and disclosure requirements, including a new QJSA notice, waiver and if necessary, spousal consent.
- Payments under the new form of payment must satisfy the defined benefit annual limitation rule as of the new annuity starting date based on the applicable interest rate and the applicable mortality table for that date, taking into account prior payments.

Currently, most plans do not permit participants to change the form of payment after their annuity starting date due to concerns about participants "selecting against" the plan. However, we will accommodate plan sponsors that want to make this option available to participants.

Increasing Annuities

In general, annuity payments (whether paid over a participant's life, joint lives, or a period certain) must be nonincreasing. However, the final rules permit increased payments resulting from:

- Plan amendments that increase benefits;
- Adjustments to reflect an annual cost-of-living increase that meets specific rules;
- A percentage increase that occurs at specified times (e.g., at specified ages);
- "Pop-up" payments resulting from the beneficiary's death or the participant's divorce; or

- A conversion by a beneficiary of the survivor portion of a joint and survivor annuity to a single sum cash settlement upon the participant's death.

An annual cost-of-living increase will satisfy these rules only if it is based on an annual increase in an eligible cost-of-living index for a 12-month period ending in the year during which the increase occurs or the prior year. An eligible cost-of-living index is a consumer price index (CPI) issued by the Bureau of Labor Statistics and based on prices of all items (or all items excluding food and energy). A plan that provides a ceiling on annual cost-of-living increases may allow any unused portion of an increase to be provided in a later year as long as it does not exceed an eligible cost-of-living index.

Segregated Shares

In a traditional defined benefit plan, other than a governmental plan or a non-electing church plan, the participant's surviving spouse receives a standard QPSA death benefit. Typically, a defined benefit plan does not provide a pre-retirement death benefit in the event there is no surviving spouse. However, cash balance plans tend to be more generous than traditional defined benefit plans with pre-retirement death benefits (similar to defined contribution plans) and usually offer a single sum death benefit which may be distributed among multiple beneficiaries. If a participant's hypothetical account balance under a cash balance plan is not segregated in the names of the multiple beneficiaries by the last day of the year following the calendar year of the participant's death, then the shortest life expectancy of all the beneficiaries must be used to calculate the minimum required distribution for all beneficiaries. However, if the participant's account is segregated by December 31 in the names of each of the multiple beneficiaries, then the life expectancy of each beneficiary will be applied to the beneficiary's respective share of the death benefit.

Payments to Children

If a plan makes death benefit payments to a participant's child until the child reaches the age of majority (or dies, if earlier), those payments may be treated for MRD purposes as if they were made to the participant's surviving spouse to the extent they become payable to the surviving spouse upon cessation of the payments to the child.

As a result, the child's age is not taken into account for purposes of the incidental benefit rule. In addition, the increase in the payments made to the surviving spouse when the child reaches the age of majority is not treated as a prohibited increase in benefits. A child is treated as not having reached the age of majority if the child has not completed a specified course of education and is younger than age 26, or is disabled.

Governmental Plans

Distribution Options for Governmental Plans

The final rules permit governmental plans to offer annuity options that were not permitted under earlier rules. The final rules expand the list of acceptable payment options to allow lump sum distributions to beneficiaries and provide for pop-up payments to a surviving spouse after the cessation of payments to a child.

Grandfathered Distribution Options

The final rules also provide a grandfather rule for governmental plans that were in effect on April 17, 2002. This rule provides that a payment option provided under the terms of a governmental plan as in effect on April 17, 2002 will satisfy the final MRD rules as long as it satisfies the prior MRD rules, based on reasonable and good faith interpretation of those rules.

This grandfather rule only applies to plan provisions in existence on April 17, 2002. Any new payment option in a governmental plan or change in payment options must comply with the final rules.

Effective Dates

In general, the final rules apply for purposes of determining MRDs for calendar years beginning on or after January 1, 2003. However, plans are deemed to comply with these rules for 2003, 2004 and 2005, if they comply with either the 1987 proposed rules, the 2001 proposed rules, or the 2002 temporary and proposed rules during those years.

For governmental plans, the ability to follow the old rules extends to the later of December 31, 2005, or the end of the calendar year containing the 90th day of the opening of the first legislative session of the legislative body with the authority to amend the plan that begins on or after June 15, 2004.

Next Steps

Plan sponsors should review this material to determine the impact of these final rules on both their plan's operation and their plan documents. If Prudential Retirement provides document services for your plan, we will amend your plan to incorporate the new rules when we restate the plan to comply with EGTRRA requirements. However, plan sponsors should not make design changes to their plans without first consulting the plan's enrolled actuary.

Plan sponsors that do not use a Prudential-drafted plan document should consult their attorneys to ensure their plan documents are updated in a timely manner, and then provide us a copy of the updated plan document so we can appropriately administer their plans.

If Prudential Retirement calculates benefits for your plan, we will follow these new rules for annuity starting dates beginning on or after January 1, 2006.

Pension Analyst by Prudential Retirement

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