

Recent Changes to the Minimum Distribution Rules For Tax-Qualified Retirement Plans

By Daniel N. Janich

The Small Business Job Protection Act (SBJPA 96), signed into law by President Clinton on August 20, 1996, liberalized the minimum distribution rules applicable to qualified plans. Several issues relating to how this change can be implemented were left unaddressed in SBJPA 96. A series of Internal Revenue Service pronouncements, however, provided plan sponsors with additional guidance as to how they may operate their plans consistent with the new minimum distribution rules. These notices, announcements and proposed regulations afford plan sponsors some flexibility so that employers can consider several plan design alternatives.

In general, under the old rules, benefits were required to commence no later than April 1 following the calendar year in which the participant attained age 70 ½, regardless of whether the participant terminated employment prior to that date. SBJPA 96 modified this rule with respect to participants who are non-5 percent owners of the employer contributing to the plan. With respect to these participants, distributions need not commence until the April 1 following the *later* of (1) the end of the calendar year in which the participant retires or terminates employment, or (2) the end of the calendar year in which the participant turns age 70 ½. The revised rules still require participants who own more than 5 percent (referred to hereafter simply as “5 percent owners”)¹ to receive distributions no later than April 1 of the calendar year in which they turn age 70 ½, even if they are still employed. What follows is a summary of IRS guidance on the minimum distribution rules issued since enactment of SBJPA 96.

IRS Notice 96-67: Participants who attain age 70 ½ in 1996 but do not retire by the end of 1996.

The notice addresses two important issues: (1) whether a minimum distribution must be made by April 1, 1997, for a participant (other than a 5 percent owner) who attains age 70 ½ in 1996 but does not retire; and (2) whether a plan distribution made in 1996 to a participant (other than a 5 percent owner) who attains age 70 ½ in that year but who does not retire by the end of 1996 is treated a “required distribution” for purposes of the rollover distribution rules. As to the first issue, the IRS determined that required distributions for participants (other than 5 percent owners) who reach age 70 ½ in 1996 but do not retire are not required to begin until April 1 of the calendar year following the year in which the participant actually retires. As to the second issue, the IRS stated that distributions made in 1996 are treated as “required distributions,” while distributions made in 1997 and thereafter are not. To the extent that distributions are not “required distributions,” they are eligible for rollover treatment and subject to the mandatory 20

¹ An individual is considered to own more than 5 percent if he or she was a more-than-t percent owner for purposes of the top-heavy rules. (Prop. Reg. 1.401(a)(9)-1; see Code Section 416(i))

percent tax withholding rules. The rollover issue is also addressed in Notice 97-75, discussed below.

IRS Announcement 97-24: Plan amendment not prerequisite to offering deferral option.

The General Explanation of Tax Legislation enacted in the 104th Congress, prepared by the staff of the Joint Committee on Taxation (“1996 Bluebook”), states that a plan sponsor may provide a participant (other than a 5 percent owner) who attains age 70 ½ in 1996 with the option to defer the receipt of required distributions until April 1 of the year following actual retirement.

The SBJPA 96, however, did not address whether a formal plan amendment is required before this option may be offered. Announcement 97-24 provides guidance to employers who are interested in offering their employees (other than 5 percent owners) this option even if the plan has not yet been formally amended. A plan with provisions under the old distribution rules will not fail to satisfy the plan qualification requirements merely because participants (other than 5 percent owners) are offered the deferral option *before* the plan is formally amended. When the plan is formally amended, however, plan sponsors offering this option must amend their plans retroactively.

The 1996 Bluebook suggests that employees who have attained age 70 ½ and who have already begun to receive distributions under the prior rules may be offered an election to stop receiving distributions until after actual retirement. Announcement 97-24, however, did not address this issue, and simply cautioned employers that an election to stop receiving distributions may violate the participant and spousal consent, and joint and survivor annuity rules. The conditions under which this election may be made and the permitted timing of related plan amendments are addressed by the IRS in Notice 97-75, discussed below.

IRS Announcement 97-70: Transitional relief for plans with required distributions between August 20, 1996 and December 31, 1997.

In Announcement 97-70, the IRS provided transitional relief to a plan required to make a minimum distribution between August 20, 1996 (i.e., the date SBJPA 96 was enacted) and December 31, 1997. In general, a plan will not be treated as failing to follow its terms merely because of a delay in making the distribution, provided that (1) the employee was given the option to defer receipt of the distribution and the participant made an election to defer by December 31, 1997 (or a makeup distribution has been made to the employee in accordance with terms set forth in this guidance), and (2) the employee option or the makeup distribution met all the plan qualification requirements of the Internal Revenue Code (except for the requirement that plans operate in accordance with their terms).

Anti-Cutback Tax Regulation 1.411(d)-4, Q&A-10: Plans may be amended to eliminate required distributions at age 70 ½ for all accrued benefits.

According to the IRS interpretation of the anti-cutback rules of Code Section 411(d)(6), the statutorily mandated payment of plan benefits beginning at age 70 ½ is an optional form of distribution that cannot be eliminated by plan amendment with respect to benefits attributable to periods of service preceding the amendment. This IRS position is subject to dispute, but objections were substantially reduced when the IRS amended the anti-cutback regulations to allow plan sponsors to adopt plan amendments that eliminate required distributions commencing at age 70 ½, even with respect to benefits that accrued before the effective date of the SBJPA 96. Under the amended regulation, plans may be amended to eliminate a pre-retirement age 70 ½ required distribution to employees who reach age 70 ½ on or after a calendar year that begins after the *later* of: (1) the adoption of the amendment, or (2) December 31, 1998. A plan that is amended pursuant to this regulation must offer employees who retire after age 70 ½ the same optional forms of benefit (except for the difference in timing of commencement) that they would have received had they retired in the year they reached age 70 ½. The amendment must be adopted no later than the last day of the first plan year beginning on or after January 1, 1999. However, if the plan sponsor intends to eliminate the mandatory distribution in 1999, the amendment must be adopted by the end of 1998. In addition, if the amendment is not adopted until after the last day of the 1999 plan year, the age 70 ½ distribution option cannot be eliminated without protecting the option on benefits that accrued through the date of the amendment for all plan participants.

IRS Notice 97-75: Coordination of revised minimum distribution rules with other plan rules and requirements.

This notice addresses several distinct issues with a focus on how the revised minimum distribution rules are to be coordinated with other plan rules and requirements. Specifically, Notice 97-75:

- *Coordinates the non-discrimination requirements with the requirement that certain pre-retirement distribution options be available to an employer at age 70 ½. To optional forms of benefit that differ only with respect to the timing of their commencement generally may be aggregated and treated as a single optional form of benefit solely for purposes of satisfying the non-discriminatory current and effective availability requirements. For example, a pre-retirement age 70 ½ distribution option that is available only to 5 percent owners may be aggregated with another optional form of benefit that differs only in the timing of the commencement of payments, if certain requirements are met.*
- *Permits plans to allow participants who commence distributions under the old minimum distribution rules to stop receiving those distributions and provides guidance on the applicable notice and spousal consent requirements. An affirmative election to stop receiving distributions is consistent with the 1996 Bluebook, which provides: “it is intended that a plan (or annuity contract) could (but would not be required to) permit the participant, with his or her consent, to stop receiving distributions until such distributions are required under the ...*

[SBJPA 96]... provision.” An election by an employee over age 70 ½ to stop distributions from a qualified plan is subject to the qualified joint and survivor annuity requirements to the extent that the plan is subject to them. The IRS provides detailed guidance describing the circumstances under which spousal consent is required upon such an election or upon recommencement of distributions.

- *Clarifies the extent to which distributions made after 1996 to an employee who has attained age 70 ½ will be considered eligible rollover distributions.* For purposes of the rollover distribution rules, certain active employees over age 70 ½ are permitted to roll over a distribution paid in 1997 that under the old minimum distribution rules would not have been an eligible rollover distribution because it would have been a required minimum distribution. In such cases, the 20 percent withholding rule applicable to rollover distributions also applies to these distributions.
- *Gives relief from the written explanation requirement under Code Section 402(f), and the mandatory 20 percent withholding requirement for certain distributions made in 1997.*
- *Provides an optional rule under which a plan may elect to use the old minimum distribution rules for all employees.*
- *Answers questions regarding the actuarial increase to be provided under a defined benefit plan for employees who retire after age 70 ½.* This provision does not apply to defined contribution plans.

Proposed Tax Regulation 1.401(a)(9)-1, Q&A D-5,D-6, and D-7: Application of the revised minimum distribution rules to trusts as designated beneficiaries.

The IRS amended the proposed regulations governing the treatment of a trust as a designated beneficiary for purposes of the minimum distribution rules as revised by SBJPA 96. Before amendment of the proposed regulations, a trust was required to become irrevocable as of the employee’s “required beginning date,” i.e., April 1 of the calendar year following the calendar year in which the participant attains age 70 ½, in order for the beneficiaries to be treated as designated beneficiaries for minimum distribution purposes. Under the proposed regulations, as amended, a trust can either be irrevocable or become irrevocable by its terms at the death of the employee rather than at the employee’s “required beginning date.”

The proposed regulations also provide an alternative to providing a copy of the trust to the plan administrator. The proposed regulations prior to their amendment required that a copy of the trust instrument be provided to the plan administrator by the earlier of the required beginning date or the date of the employee’s death. The amended proposed regulations continue the requirement that a copy of the trust instrument be provided as a method of compliance with the documentation requirement. Under the proposed

regulations, as emended, a trustee can satisfy the documentation requirement by providing, in lieu of a copy of the trust instrument, a list of trust beneficiaries (including contingent beneficiaries) and a description of their interests to the plan administrator. The employee must certify that the list is correct and complete, to the best of his or her knowledge, and that the other requirements for the treatment of trust beneficiaries as designated beneficiaries (i.e., trust is valid under stat law, and individual beneficiaries are identifiable from the trust instrument) have been satisfied. For employees who died before the “required beginning date,” the revised proposed regulations allow the trustee to satisfy the documentation requirement during the nine-month period after the employee’s death.

Conclusion

The changes made to the minimum distribution rules under the SBJPA 96 and the Internal Revenue Service guidance that followed in its wake provide plan sponsors with new plan design opportunities. In implementing these changes, plan sponsors must first consider employees over age 70 ½ who have begun receiving distributions. These participants may stop receiving distributions until April 1 of the year following retirement if the plan sponsor so chooses. Secondly, sponsors must consider employees who are or will turn age 70 ½ but who have not yet begun to receive distributions. Sponsors may allow employees who turn age 70 ½ in 1996 or thereafter the option to begin receiving distributions on April 1 of the year following the year in which they reach age 70 ½ or to defer commencement of their distributions until after they retire. This option can be made available to participants even before the plan has been amended. Alternatively, plan sponsors may eliminate altogether the mandatory distribution option at age 70 ½ for all accrued benefits if an amendment is adopted by the last day of the first plan year beginning on or after January 1, 1999. Finally, plan sponsors may decide not to change the plan’s mandatory distribution date at all. Employers may simply continue to require commencement of distributions by April 1 of the year following the year in which a participant reaches age 70 ½ regardless of whether the participant remains employed.

Whatever the plan design choices, employers should choose the plan design options that best suit the company’s overall objectives, and begin the task of implementing such changes to the plan now. By taking the time to fully understand these changes and their relative impact upon the plan, a plan sponsor can minimize the risk that its plan will be administered in a manner inconsistent with the minimum distribution rules and thus avoid either expensive corrective plan actions or the risk that the plan’s tax-qualified status may be lost.