

November 14, 2017

Delaying the Inevitable

Required Minimum Distributions for Defined Contribution Plans

By Donna Byers

We've all heard the saying "Nothing in life is certain except death and taxes." And while that's true, when it comes to the latter, a qualified retirement plan account holder may choose to delay — up to a point — paying taxes on retirement savings by keeping them in a qualified retirement plan or IRA. The aforementioned "point" eventually arrives in the form of a required minimum distribution (RMD).

Required beginning date

An RMD is a payment made to an account holder after attaining age 70½. Typically, an account holder's initial RMD is due April 1 of the calendar year immediately following the later of (1) the year the account holder reaches age 70½ or (2) retires from employment with the employer maintaining the plan. There is an exception to this rule, however, as the regulations require five-percent owners to begin receiving RMDs by April 1 of the calendar year immediately following the calendar year in which they reach age 70½ regardless of their employment status.

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All subsequent RMDs must be paid by December 31. This includes the year in which the initial RMD is paid; ergo, account holders who receive their initial distribution using the April 1 grace period will receive a second distribution

in December of the same year. A plan sponsor may want to let account holders know that they can avoid receiving two RMDs in the initial year by taking their initial distribution in the year they attain 70½, rather than waiting until April 1 of the following year.

It should be noted that a change in employment status where the account holder is considered retired by the plan sponsor but continues to work for the plan sponsor in a different capacity is not a retirement for RMD purposes. For instance, a phased retirement reduction in hours is not a retirement as long as that account holder continues to work for the plan sponsor.

While many plans set the required beginning date as April 1 of the calendar year after the later of attainment of age 70½ or retirement date, Treasury Regulation Section 1.401(a)(9)-2 permits a plan to set the required beginning date for all account holders as April 1 of the calendar year following attainment of age 70½. To ensure RMDs are made in operational compliance, it is important to check the plan document to confirm a plan's required beginning date. For more information about the required beginning date, refer to IRC Section 401(a)(9)(C).

Distribution calendar year

An RMD is required to be paid for each distribution calendar year. As noted above, for most account holders, the first distribution calendar year is the later of the year that an account holder attains age 70½ or the year an account holder retires (do not confuse the initial distribution year with the year in which the grace period of April 1 occurs). If any payment is made from the plan to the account holder during the distribution calendar year, the RMD must also be paid during the distribution year. Note that the RMD must be paid first before any other payments from the plan.

For example, John, who is 72, retires from ABC Company on June 30, 2017. John plans to roll over his account balance in ABC Company's 401(k) plan into an IRA before the end of 2017. The initial distribution calendar year is 2017, and although his first RMD payment can be delayed to April 1 of 2018, it must be made during the distribution calendar year if any payment is made from the plan during the distribution year. Before John's account balance can be rolled over, he must be paid his first RMD.

Once the RMD is paid, the remaining balance in John's account will be rolled over. The qualified plan that held John's account balance on December 31, 2016, is the plan responsible for paying the RMD. The rollover institution is responsible for RMDs payable after receiving the rollover funds.

Five-percent owner determination

Determination of a five-percent owner is based on the ownership interest with respect to the plan year ending in the calendar year in which the individual attains age 70½. The five-percent owner is determined from that first distribution calendar year and is not re-evaluated after that year. If a five-percent owner sells his interest after this date, he must continue to be paid RMDs from the plan, as a change in ownership after RMDs commence does not change the requirement that the RMDs are to be paid. Family attribution rules do apply in this determination (IRC Section 318(a)(1)).

A plan sponsor should establish a policy to address how non-five-percent owners will be handled upon rehire.

Continuing RMDs

While a five-percent owner must continue receiving RMDs once distributions commence, there is nothing in the regulations to indicate that suspension of RMDs from qualified plans is allowed for a rehired account holder who is not a five-percent owner. A plan sponsor should

establish a policy to address how non-five-percent owners will be handled upon rehire. The conservative approach is to continue RMDs from qualified plans once they have commenced.

TEFRA 242(b) election caution

For certain qualified plans, a TEFRA 242(b) election specifying when distribution will occur and signed prior to 1984 requires no minimum distribution. This is true even if the account holder has reached his required beginning date. A payment of any RMD prior to severance from employment after age 70½ will cause this election to be revoked and all missed RMDs will be required to be made up.

Aggregating RMDs

IRAs are allowed to be aggregated when calculating the RMD due from all IRAs owned by an individual, and the total amount can be taken from any combination of those IRA accounts. This is not the case, however, for qualified plans. There is no RMD aggregation for most qualified plans, and each qualified plan must separately calculate and pay (at least) the RMD amount. However, two or more 403(b) annuity contracts or custodial accounts may be aggregated. When 403(b) contracts or accounts are aggregated, they must be aggregated separately for beneficiary or account holder accounts (a death-beneficiary's 403(b) account cannot be aggregated with the individual's employee 403(b) accounts).

IRA rollover to a qualified plan under Revenue Ruling 2004-12

RMDs may be deferred when rolling from a traditional IRA to a qualified plan. Revenue Ruling 2004-12 allows a traditional IRA of a non-five-percent owner less the IRA RMD due for the year to be rolled into a qualified plan and defer RMDs on the IRA money rolled into the plan until April 1 after retirement. The qualified plan would need to define the required beginning date for non-five-percent owners as April 1 of the year following the later age 70½ or retirement. The plan would also need to accept rollovers of pretax funds from a traditional (non-Roth) IRA.

RMD calculation

The RMD calculation is the fair market value of the account balance as of December 31 of the year preceding the distribution year (i.e., if the distribution calendar year is 2017, the RMD calculation is based on the fair market value as of December 31, 2016) divided by the account holder's life expectancy factor.

A non-calendar year balance forward plan should be adjusted for any contributions or distributions occurring after the last valuation through December 31.

Most plans will use the Uniform Lifetime Table to calculate the distribution period amount due to be paid; however, the Joint Life Expectancy Table is used when the account holder's spouse is (1) the sole beneficiary and (2) is more than 10 years younger than the account holder. The applicable table factor is based on the account holder's age as of the distribution calendar year, and the factors decrease each year.

The RMD calculations are further complicated if there are multiple beneficiaries or a death.

The RMD calculations are further complicated if there are multiple beneficiaries or a death. In the case of a death, determining factors are whether there is a designated beneficiary, and, if so, the beneficiary's life expectancy, and whether the account holder died before or after required minimum distributions began.

Failure to pay RMDs timely

When the RMD amount is greater than the actual amount distributed, IRC Section 4974 imposes a tax of 50% on the shortfall. This tax is imposed on the account holder or beneficiary – not on the plan. The tax may be waived if the amount distributed during the year was due to reasonable error and reasonable steps are taken to remedy the shortfall.

New correction rules were released August 10, 2016, on Form 14568-H and on the IRS website for plan sponsors.

Through a Voluntary Correction Program (VCP) filing under findley.com

the IRS's EPCRS program, plan sponsors may request relief from the IRC Section 4974 excise tax on behalf of affected account holders. If the only failure in the VCP submission is the RMD failure subject to IRC Section 4974 excise tax, a plan sponsor may receive a discount on the compliance fee.

Depending on plan circumstances, a plan sponsor may also use the Self Correction Program (SCP) to correct an RMD failure, even if the plan is under examination; however, the excise tax owed by the account holder under IRC Section 4974 cannot be waived under the SCP.

Under either program, the correction results in the distribution of the required RMD amount, plus applicable investment earnings.

In perspective

The rules governing required minimum distributions are complex, and exceptions to the rules abound. Plan sponsors should check their plan document to be sure RMDs are in operational compliance. Additionally, plan sponsors should educate account holders about the rules related to RMDs so that account holders are aware of tax implications and potential penalties related to RMDs.

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