March/April 2015
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RETIREMENT NEWS

REQUIRED minimum distributions for 5% owners

For purposes of required minimum distributions (RMDs), the definition of a "5% owner" is an individual who owns more than 5% of the company sponsoring a qualified retirement plan. The required beginning date (RBD) for 5% owners to begin taking RMDs is April 1 of the year after they reach age 70½, regardless of whether they are still working.

It's possible for an individual's ownership percentage to change. The timing of such a change can have a critical impact on whether the individual is required to take an RMD. An explanation of the current rules for 5% owners follows, as well as some examples that outline how ownership changes can affect RMD requirements.

When are RMDs "locked in"?

Under the final RMD regulations, if an individual is a 5% owner, his or her RBD is April 1 of the year after he or she reaches age 70½. Whether the individual is a 5% owner is determined by whether he or she owns more than 5% of the company on any day in the plan year that ends in the year he or she attains age 70½.

If an individual's ownership percentage drops to 5% or less within that time frame (or any year thereafter), he or she will still be required to start taking RMDs by April 1 of the year after reaching age 70½ (and to continue taking RMDs thereafter).

Example 1:

A client was a 5% owner in 2014 through the family attribution rules because his wife owned 100% of the business. He reached age 70½ in 2014, the same year his wife sold the entire business. Is he still considered to be a 5% owner for RMD purposes?

Yes. When the plan year is the calendar year, if you are a 5% owner on any day in the calendar year in which you attain age 70½, then you are a 5% owner for RMD purposes. In this example, the husband must start taking RMDs by April 1, 2015.

Example 2:

A 74-year-old 5% owner began taking RMDs from his company's 401(k) plan when he attained age 70½. He is still working for the same company and recently sold his entire ownership interest in the company. Must he continue taking RMDs?

Yes. The determination of who is a 5% owner for RMD purposes is determined by the person's ownership interest in the plan year ending in the year the individual attains age 70½. If a 5% owner wishes to sell his or her interest after that date, RMDs must continue, regardless of ownership status.

Example 3:

Following this rule can be more challenging for off-calendar-year plans. In this example, the 401(k) plan year is July 1, 2013, to June 30, 2014. A 5% owner sold his interest in the company on July 12, 2014, and turned age 70½ on July 31, 2014. The plan year ending in the calendar year the individual attains age 70½ is the plan year ending June 30, 2014. Since the individual was a 5% owner during the plan year (July 1, 2013, to June 30, 2014), he must begin taking RMDs, regardless of the fact that he sold his interest before actually reaching age 70½. His RBD is April 1, 2015.

The answer would be the same if the 5% owner had sold his interest on July 12, 2013, for example, because that was still during the plan year ending in the calendar year during which the individual reached age 70½.

This issue:

The TEFRA 242(b) election

The Tax Equity and Fiscal Responsibility Act of 2002 (TEFRA) introduced RMDs to corporate plans and permitted individuals who filed a TEFRA 242(b) election to follow the distribution rules that applied to their qualified plans in 1983.* The election generally delayed the date working employees had to begin taking distributions beyond age 70½. They could wait until they severed employment. The election required participants to select from the plan's distribution rules at that time and was available to both 5% owners and non-5% owners. Note that some firms had all their employees make the election.

There are individuals, usually professionals like doctors or lawyers, who filed such an election and are still working. And even though they are well beyond age 70½, they have not started taking distributions. For example, when an institution was acquired, a review of RMDs by individuals' ages discovered a one-person plan with an 84-year-old doctor who had timely filed a TEFRA 242(b) election delaying the start of distributions until he retired. He was still working and had never taken RMDs.

Note that if there is an involuntary revocation of the TEFRA 242(b) election, the individual must make up missed payments.

Permitted RBD delays

Under current regulations, there are two events that permit the delay of an individual's RBD. One is for an annuity payment from an insurance company involved in a state insurer delinquency program. The other is if the individual is in the midst of an 18-month qualified domestic relations order (QDRO) period.

Plans subject to the qualified joint and survivor annuity rules

For plans subject to spousal consent requirements, spousal consent is required for RMDs. Typically, a blanket spousal consent is acceptable (i.e., one spousal consent for all future RMDs).

Plan documents define RBD

A document may permit non-5% owners who work after age 70½ to wait until retiring before reaching RBD. Alternatively, a plan document may define RBD as April 1 after reaching age 70½ for all individuals.

* The TEFRA 242(b) election had to be executed by December 31, 1983.

Excess Elective Deferrals

With the 2015 tax season in full swing, this is a good time for a brief review of the rules governing the treatment of excess elective deferrals. The IRC Section 402(g) limit on elective deferrals for the 2014 calendar year was $17,500 for individuals under age 50. Individuals age 50 or older could contribute an additional $5,500 as catch-up contributions for a total 402(g) limit of $23,000. The 402(g) limit is applied on an individual taxpayer basis to the aggregate of all cash or deferred arrangements (including 401(k) and 403(b) plans) the individual participates in during a given calendar year. This is a calendar-year limit, not a plan-year limit for off-calendar-year plans.

Errors can be tough to spot. Most payroll systems are programmed to prevent excess deferrals. As a result, excess deferrals do not typically occur when an employee works for only one employer during a calendar year and contributes to only one 401(k) plan. Excess deferral errors tend to occur when individuals have either changed employers or participated in more than one plan of unrelated employers during a calendar year. In these situations, employers are generally not aware of amounts an individual has contributed to another plan(s). Thus, employers would not be aware of a potential 402(g) violation until a participant notifies them of the excess deferral amounts.

Correction procedures. When elective deferrals exceed the annual limit, the excess deferral amount plus earnings must be distributed by April 15 of the following calendar year. For example, an excess deferral related to the 2014 calendar year must be distributed from a plan by April 15, 2015. Excess pretax deferral amounts are taxable in the year they were contributed, while earnings associated with the deferrals are taxable in the year the excess is distributed. Excess designated Roth deferral amounts are not taxed if distributed prior to April 15; however, the earnings are taxable in the year distributed.

The distribution of excess deferrals is not treated as a premature distribution, although the distribution of earnings is. Excess deferrals and the earnings on the excess may not be rolled over, since they are not eligible rollover distributions. Plans that permit designated Roth and pretax deferrals can allow participants with both types of excess deferrals to decide which type is distributed.

Adverse consequences. If the April 15 distribution deadline is not met, excess deferrals must still be distributed, but amounts will be subject to ordinary income tax as a distribution. Thus, the employee will pay tax in the year the excess deferral was made (excess deferrals may not be deducted) and again in the year the elective deferral is ultimately distributed.

Failure to refund excess deferral amounts is a plan disqualifying event. Therefore, plan sponsors should take prompt action when they become aware that an excess deferral has occurred.

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Addressing the lifetime income stream issue

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Individuals currently face a greater responsibility for managing their own assets for retirement than in the past. The trend away from defined benefit (DB) plans and toward defined contribution (DC) plans is one reason. Another is the increase in life expectancies leading to longer retirements, which could result in participants outliving their retirement savings.

As a result, there have been a number of changes aimed at providing individuals with an under-standing of the need to generate a lifetime stream of income and the options for doing so. There has also been a push for products that allow assets in DC plans to produce such an income stream.

Over the past several years, the Internal Revenue Service (IRS), the Department of Labor (DOL), and the Pension Benefit Guaranty Corporation (PBGC) have responded to this need by providing new regulations, enhancing existing rules, and issuing proposed rules, all of which are designed to provide individuals with a lifetime stream of income throughout retirement. Following is a general overview of some recent concepts.

QLACs

A qualified longevity annuity contract (QLAC) is a straight-life annuity in a DC plan that can be purchased by a participant using his or her existing account balance. QLACs became effective July 2, 2014. A QLAC begins payout at an advanced age (e.g., 80 or 85). Amounts used to purchase a QLAC are excluded from a plan participant's annual minimum required distribution (RMD) from age 70½ until the annuity payments begin. Once annuity payments begin, amounts paid from the annuity would count toward satisfying the RMD of the annuity asset.

The current limit on the amount a participant may use to buy a QLAC is the lesser of 25% of the participant's account balance or $125,000. Cost-of-living adjustments will be made in increments of $10,000. If the participant dies before the amount he or she paid for the annuity premium has been paid out, the participant's beneficiary may receive a refund of the remaining premium amount. Plan sponsors are not required to offer a QLAC, and companies will likely need time to develop these new products.

TDF annuities

On October 24, 2014, the IRS issued Notice 2014-66 permitting qualified DC plans to offer target date funds (TDFs) with lifetime income investment options (including deferred annuities). Under this type of arrangement, a plan's lineup of investment options would include a series of TDFs. Each TDF would hold investments appropriate for a specific participant age group, and some would hold deferred annuities. As the age of each group advances, the portfolios of TDFs for older age groups would have a greater portion of deferred annuities. When the TDF reached its target date, it would dissolve and participants with an interest in that TDF would receive an annuity certificate that would provide either immediate or deferred payments.

Rollovers from DC plans to DB plans

Some employers sponsor both a DC plan and a DB plan. DB plans have a lifetime income benefit option. In 2012, the IRS published Revenue Ruling 2012-4, which permits participants who are ready to begin receiving retirement benefits to roll over some or all of their DC plan account balance to the employer's DB plan and convert the rollover amount into an immediate annuity within the DB plan.

On November 25, 2014, the PBGC published a final rule that clarifies the treatment of rollovers from DC plans to DB plans when a DB plan terminates in an underfunded status. The final rule says that amounts previously rolled into a DB plan from a DC plan are not subject to the PBGC's maximum guarantee able benefit limitations (i.e., the limitations that apply when the PBGC steps in to take over a bankrupt plan). Thus, DC rollover amounts are protected, as are the amounts due from the PBGC's benefit formula for the DB plan.

Proposed benefit statement rules

In 2013, the DOL's Employee Benefit Security Administration (EBSA) proposed rules that would require lifetime income illustrations to be incorporated into periodic benefit statements so individuals could see estimates of their lifetime income payments based on their current DC account balances. The EBSA believes that illustrating account balances as income streams will motivate DC plan participants to save more so they will be better prepared for retirement.

RECENT developments

MEP Form 5500 change

The DOL published final rules that became effective for plan years beginning after December 31, 2013, which make reporting changes to annual Form 5500 filings for multiple employer plans (MEPs). A MEP is a plan that is maintained by more than one unrelated employer and is not a "single employer plan" or a "multi-employer plan" for Form 5500 filing purposes. 2014 Forms 5500 and 5500-SF will require filings for MEP plans to include an attachment listing participating employers along with figures that reflect percentages of estimated plan contributions related to each participating employer.

Revised 402(f) notices

Qualified plan sponsors are required to provide participants with a Section 402(f) notice 30 to 180 days before the participants receive an eligible rollover distribution. A 402(f) notice is a plain-language explanation of a participant's distribution options and how distributions will be taxed, including possible special tax treatment. It is intended to help participants decide whether to make a direct rollover or have the distribution made payable to themselves. It spells out the impact of the 20% federal tax withholding on an eligible rollover distribution and how to avoid the withholding by directly rolling over the distribution to an IRA.

On November 14, 2014, the IRS revised the language in the 402(f) special tax notice. The most notable change is the way pretax and after-tax amounts are calculated when a participant requests that a distribution be sent to multiple destinations at the same time (e.g., sending some funds to a new employer's qualified plan, some to a traditional IRA, and some to the participant). The IRS updated its two model 402(f) notices (one for Roth and the other for non-Roth contribution sources). The last time the IRS changed the language in the 402(f) notices was in 2009. The revised notices apply to distributions that occur after January 1, 2015.

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