EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION

PROPOSED UPDATES TO REQUIRED MINIMUM DISTRIBUTION AND ROLLOVER REGULATIONS FOR RETIREMENT PLANS

The Setting Every Community Up for Retirement Enhancement Act of 2019 (the "SECURE Act") was approved in December 2019, and made significant changes to the "required minimum distribution" rules under Section 401(a)(9) of the Internal Revenue Code of 1986, as amended (the "Code"). Those rules set forth the payment deadlines and minimum payment amounts applicable to participants and beneficiaries in employer-sponsored retirement plans and to IRA owners and their beneficiaries.[1]

In February 2022, the IRS issued proposed regulations under Sections 401(a)(9), 403(b), 408 and 457(b) of the Code that reflect the SECURE Act changes. The IRS also proposed revising the regulations regarding rollovers between retirement plans and/or IRAs to accommodate the impact of the required minimum distribution changes as well as to incorporate other statutory changes since the current rollover regulations were issued.

Background to SECURE Act Required Minimum Distributions Changes

Under pre-SECURE Act law, a participant in a qualified retirement plan, 403(b) plan or eligible 457(b) plan generally was required to commence "required minimum distribution" payments from the plan no later than April 1st of the year following the year he/she attained age 70½ (or, if the participant was still employed at age 70½ and not a "5% owner" of the employer, as of the April 1st following the year in which the participant terminated employment with the employer). IRA owners were required to commence payment by April 1st after attaining age 70½. The SECURE Act extended this deadline, allowing a participant or IRA owner who had not attained age 70½ by December 31, 2019[2] to wait until April 1st after the year in which the participant attains age 72 to commence payments. A participant in a plan who is still employed at that point and not a "5% owner" can continue to delay payment until April 1st after the year in which he/she terminates employment; as under previous law, this extension until retirement does not apply to IRA owners. In any event, the relevant April 1st is referred to as the "required beginning date."

[1] This newsletter focuses on the required minimum distribution rules primarily with respect to their application to private-sector employer-sponsored retirement plans. IRAs are also subject to the required minimum distribution rules, although some details differ and owners of Roth IRAs are not required to take required minimum distributions during their lifetimes. Government and church plans likewise are affected by the required minimum distribution rules, but with various exceptions and special rules.

[2] That is, who was born on or after July 1, 1949.

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The SECURE Act also changed the required minimum distribution rules applicable to non-spousal beneficiaries of deceased participants in defined contribution plans and IRAs. Previously, these beneficiaries could, in most cases, elect to receive payment of death benefits over their own life expectancies, if the plan permitted. Under the SECURE Act, a beneficiary who is an individual human, or a trust that qualifies to use the individual rules, generally must complete payment from a defined contribution plan (or IRA, as applicable) within 10 years of the participant's death, unless the beneficiary is an "eligible designated beneficiary." An "eligible designated beneficiary" is a beneficiary who is the participant's surviving spouse, the participant's minor child (in which case, the 10-year deadline is calculated from the date the beneficiary reaches the age of majority), a beneficiary who qualifies for an exception by reason of a qualifying disability or chronic illness, or a beneficiary who is not more than 10 years younger than the participant.

The new rules apply to beneficiaries of defined contribution plan participants and IRA owners who die after December 31, 2019, as well as to successor beneficiaries for beneficiaries of participants who had died on or before December 31, 2019, if the original beneficiary dies after December 31, 2019 and before full payment of the account.[3] However, collectively bargained plans and governmental plans have a delayed effective date for these changes, and distribution schedules under qualified annuity contracts that meet specified conditions and were already in effect and binding as of the date of the SECURE Act are not affected. In addition, defined benefit plans' death benefit payment deadlines were not changed by the SECURE Act. Accordingly, defined benefit plan beneficiaries who are individuals or qualifying trusts continue to be eligible to take payment over their life expectancies, if the plan permits.

Spousal beneficiaries continue to have the right to calculate required minimum distribution payments based on their own life expectancies, and to recalculate their life expectancies each year. Spousal beneficiaries also retain the right to delay commencement of payment longer than non-spousal beneficiaries. Under pre-SECURE Act law, the spousal beneficiary of a participant who died prior to the required beginning date could delay payment until the end of the year the participant would have attained age 70½, or until the end of the year after the participant's year of death, if later. The SECURE Act allows the delay to extend until the year the participant would have attained age 72 (or until the end of the year after the year of death, if later), in the case of participants who would not have turned 70½ as of December 31, 2019. The IRS' proposed regulations confirm that the spouse of a participant who died before 2020 but who would not have reached age 70½ by December 31, 2019 (i.e., who was born on or after July 1, 1949) can use the age 72 deadline, rather than age 70½.

For both defined benefit plans and defined contribution plans as well as IRAs, if a participant dies prior to reaching the required beginning date, beneficiaries other than individual humans or qualifying trusts (e.g., a charitable organization, an estate, or a trust that does not meet IRS requirements to be treated as an individual human for this purpose) continue to be subject to the requirement that payment be completed in full by the end of the calendar year containing the fifth anniversary of the participant's death.

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[3] The IRS' proposed regulations clarify how to determine when a beneficiary is considered to have died prior to December 31, 2019 (for example, if there are multiple beneficiaries, the oldest beneficiary is the applicable beneficiary for this purpose).

Key Provisions of the Proposed Required Minimum Distribution Regulations

The IRS opted to reorganize the existing required minimum distribution regulations in their entirety, rather than just revising provisions that were affected by the SECURE Act changes. Aside from changes motivated by statutory updates, the proposed regulations generally are consistent with the existing regulations and sub-regulatory guidance. However, the IRS has added additional details and examples to address common questions that had arisen under existing law as well as making alterations to accommodate the SECURE Act. The following sections describe a number of the notable provisions in the proposed regulations.

Clarifications Relating to the New 10-Year Deadline for Defined Contribution Plans and IRAs

If a defined contribution plan participant or IRA owner dies before the required beginning date,[4] the beneficiary must complete payment by the end of the calendar year containing the fifth anniversary of the participant's death, if the beneficiary is not an individual or a qualifying trust, or by the end of the calendar year containing the 10th anniversary of the participant's death if the beneficiary is an individual or qualifying trust but is not an "eligible designated beneficiary." In most cases, an eligible designated beneficiary of a deceased participant can take payment commencing the year after the participant's death (or, if later, the year the participant or IRA owner would have turned 72, if the beneficiary is a surviving spouse) and continuing annually over the eligible designated beneficiary's life expectancy, calculated in accordance with IRS guidelines. However, if the eligible designated beneficiary is a child under the age of majority (age 21, for this purpose) and does not otherwise qualify as an eligible designated beneficiary, distribution must be completed by the end of the 10th calendar year following the year the child attains age 21. In contrast, if the child also meets the requirements to be a disabled beneficiary on the grounds of disability or chronic illness, the life expectancy rule can continue to apply.

One important question that the IRS answered in the proposed regulations is whether beneficiaries subject to the 10-year rule need to take annual distributions, or can wait until the 10th year and take a single payment. If the participant dies prior to the required beginning date, the beneficiary can wait until the 10th year. This is consistent with the current approach to the five-year deadline applicable to beneficiaries who are not individuals or qualifying trusts. However, if the participant dies after the required beginning date and the beneficiary is an individual or qualifying trust but not an eligible designated beneficiary, life expectancy distributions must continue annually, until either expiration of the life expectancy or the end of the 10th year (whichever comes first) triggers the requirement to take payment of the entire remaining account.

The proposed regulations also set forth rules and deadlines for determining whether a beneficiary is an eligible designated beneficiary by reason of a disability or chronic illness. The regulations detail documentation requirements that must be provided and the standards that must be met.

- With respect to disability:
  - For someone age 18 or older, a disability exists if, as of the date of the participant's death, the beneficiary is unable to engage in any substantial gainful activity by reason of any medical

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[4] A Roth IRA owner is automatically considered to have died prior to the required beginning date.

determinable physical or mental impairment that can be expected to result in death or to be of long-continued and indefinite duration.

- A beneficiary under age 18 is disabled on the date of the participant's death if the beneficiary has a medically determinable physical or mental impairment that results in marked and severe functional limitations and can be expected to result in death or to be of long-continued and indefinite duration.
- If the Social Security Administration has determined that an individual was disabled as of the date of the participant's death, that is considered conclusive proof of disability.

- A chronically ill beneficiary must be certified by a licensed health care practitioner to be unable to perform (without substantial assistance from another person) at least two activities of daily living for an indefinite period which is reasonably expected to be lengthy in nature (which period, the IRS noted, cannot be "merely for 90 days").

Identifying Beneficiaries

The IRS has retained the existing regulations' structure allowing an account or benefit to be subdivided among multiple beneficiaries and thereafter to allow each beneficiary to determine required minimum distributions separately, if certain timing and other requirements are met. In cases in which this separate treatment is not available, however, the regulations provide rules as to which beneficiary determines the payment deadline (and, when applicable, the measuring life). In cases where beneficiaries receive their interests through a trust, the proposed regulations detail which trust beneficiaries must be taken into consideration and when, and describe the circumstances in which a trust qualifies to be covered by the required minimum distribution rules applicable to individuals rather than those applicable to estates, charities, and other non-individual beneficiaries.

While keeping the general concept behind separate treatment intact, the proposed regulations add clarity to the timing and other requirements for separate treatment and to the administration of situations not entitled to separate treatment, and provide more information about how to apply the rules to trusts and their beneficiaries. In particular, the proposed regulations address the complexity created by the SECURE Act's introduction of a difference in treatment between eligible and non-eligible designated beneficiaries for defined contribution plans and IRAs in situations involving multiple beneficiaries and trusts.

As under existing law, a plan or IRA's beneficiary designation process (and default provisions, in the absence of a valid designation) will be used to determine the identity of the beneficiary or beneficiaries. While the IRS allows a participant or IRA owner to refer out to other documents (such as a will or living trust) or to name beneficiaries in general terms (e.g., "my children, per stirpes") without preventing a beneficiary from qualifying as identifiable for purposes of serving as a measuring life under the required minimum distribution rules, plan participants and IRA owners should be aware that plan administrators and IRA custodians may be less flexible. Plans, in particular, generally require a fairly high level of specificity, in order to ensure that the beneficiary can be contacted when the time comes. Plans, unlike IRAs, also are subject to federal rules that make a surviving spouse the automatic beneficiary of either half or all of the benefit (depending on the plan) unless the spouse affirmatively consents to the designation of another beneficiary. Beneficiary designation forms must comply with all applicable rules, and participants and IRA owners should review their designations regularly to keep them up to date.

Early Payments

As under the existing regulations, participants and beneficiaries can opt to take earlier and/or larger payments than the required minimum distribution rules mandate, subject to the plan's payment rules. The IRS also noted the possibility that a plan might *require* payments earlier than the regulatory deadline. A participant or beneficiary cannot credit distributions taken prior to the year for which a required minimum distribution is due against that subsequent year's required minimum distribution. If a person does opt to take early payments, those payments generally do not need to comply with required minimum distribution rules. However, consistent with the current regulations, a person who commences payment under an annuity arrangement is considered to have become covered by the required minimum distribution rules when the annuity begins, and the annuity must be designed to satisfy the required minimum distribution rules even with respect to payments prior to the required beginning date.

Early payments that are not part of an annuity generally are not considered required minimum distributions, and hence can be rolled over if not otherwise disqualified from rollover treatment. Likewise, amounts in excess of the required minimum distribution for a year can be rolled over if otherwise eligible. The rules are more complicated, however, if the plan provides for a "uniform required beginning date" for both 5%-owners and non-5%-owners, denying non-5%-owners the ability to defer distribution past age 72 if the participant remains employed.

The IRS did not address whether a plan could retain the existing age 70½ deadline, although there does not appear to be any barrier to doing so if the plan stated that deadline prior to the statutory change and has not been amended since then.[5] The IRS also did not address in detail the possibility of an earlier payment deadline, such as the rule imposed by many pension plans that payments start no later than a participant's normal retirement date (or in the case of a participant still employed as of his or her normal retirement date, promptly upon the participant's termination of employment), simply noting that a plan might require earlier payment. Nothing in the statutory changes, however, indicates that a plan could not continue to enforce a previously permissible deadline.

In terms of beneficiary distribution options, the IRS noted that a defined benefit plan could require some or all beneficiaries to use the five-year rule even if they would legally qualify for the life expectancy rule, and that a defined contribution plan could require some or all eligible designated beneficiaries to use the 10-year rule rather than the life expectancy rule. The IRS also confirmed that a plan could allow a beneficiary to select among permissible options. The IRS did not mention the possibility of a defined contribution plan continuing to enforce a five-year deadline, if the plan previously had barred life expectancy payouts, or of continuing to enforce an even earlier payment deadline. For example, many plans require beneficiaries to take payment promptly upon the participant's death. Again, however, nothing in the statutory changes suggests that a previously permissible deadline has become problematic. Accordingly, absent IRS guidance to the contrary, plans should be able to continue enforcing existing provisions.

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[5] The IRS did not say whether a plan could now impose an age 70½ deadline if it previously incorporated the statutory deadline by reference, or whether that would be considered an impermissible elimination of a payment timing option when the payment deadline was changed by statute.

It is less clear whether a plan can begin requiring earlier payments than it previously had. For example, defined contribution plans that previously allowed beneficiaries to take life expectancy payouts may no longer be inclined to do so, given the complexity of the new regime. However, given the general permissibility of elimination of defined contribution plan extended payout options, so long as a lump sum remains permissible, it seems logical to expect that defined contributions plans could eliminate installment or other periodic payment options for beneficiaries if they wish to do so,[6] whether or not they can also enforce an earlier commencement deadline. Hopefully, the IRS will provide additional clarity on this point.

On the opposite side, the IRS also did not address a situation in which a plan allows in-service payment only to someone who has reached the required beginning date. When the Small Business Jobs Protection Act of 1996 allowed non-5%-owners to begin deferring payments until termination of employment, the IRS required special protections for the age 70 ½ payment access right.

Changes in Time and Form of Payment Under an Annuity

The IRS has retained the general rule that payments that have begun under an annuity form of payment cannot subsequently be increased or recalculated over a different period of time, except in the case of certain specified exceptions. For example, a participant who commenced payment while employed still can make a new payment election at the time of retirement. A terminating plan likewise can permit a new election. Cost of living adjustments, some types of cash refunds or accelerations in payment, variable annuity adjustments, and certain other situations also continue to allow for changes in annuity payments. While the overall concept remains consistent, the IRS has made some adjustments to the rules for annuity changes, including express authorization for increases associated with resumption of benefit payments that had been suspended under specified Code provisions.

Actuarial Increase

Except in the case of a 5% owner, a participant whose defined benefit plan benefit is delayed past April 1st of the year after the participant reaches age 70½ must have the benefit actuarially increased to reflect the delay. The increase can be subject to offset for additional benefit accruals but must be provided regardless of the participant's employment status and regardless of whether payments are suspended under Section 2530.203-3 of the Labor Regulations.[7] Congress deliberately opted not to delay this actuarial increase requirement to age 72.

Impact of Section 436

Section 436 of the Code restricts payments in excess of the amount payable under a life annuity form of payment from a defined benefit plan (or a 240-month term-certain, for a non-individual payee) if the plan is below specified funding thresholds. In some cases, that could leave a plan in the position of being

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[6] A plan relying on the qualified joint and survivor annuity rules to meet the spousal death benefit protection requirements would, of course, need to continue making a qualified pre-retirement survivor annuity benefit available to a surviving spouse beneficiary.

[7] A participant whose benefit is delayed past normal retirement date generally is entitled to an actuarial adjustment (offset by additional benefit accruals) unless the suspension rules of Section 2530.203-3 of the Labor Regulations. Suspension ceases to be an option to avoid the actuarial increase requirement for a non-5%-owner at age 70½.

prohibited from making a lump sum payment due to Section 436 restrictions, while being required to make a lump sum payment in order to satisfy the five-year rule. The proposed regulations state that the plan will be considered in compliance with the required minimum distribution rules if payment is made in the most accelerated form permissible under Section 436, and if payment is completed when and if the plan's funding improves and the Section 436 restrictions are lifted.

Minimum Distribution Incidental Death Benefit Rule

A plan must structure its benefits to ensure that it primarily provides retirement rather than death benefits. As under the existing regulations, complying with the required minimum distribution regulations' payment deadlines and minimum amounts will ensure compliance with this restriction in most cases. Plans offering joint and survivor annuities must continue to limit the available survivor percentages for non-spousal beneficiaries based on regulatory guidelines if necessary to prevent a violation of this rule, and period-certain annuity features must remain within time limits established by the regulatory life expectancy tables.

"Ancillary" death benefits not covered by the required minimum distribution rules remain permissible so long as they are appropriately limited in amount.

Qualified Longevity Annuity Contracts

The proposed regulations continue to accommodate a participant's use of a portion of a defined contribution plan account or IRA to purchase a deferred annuity contract that commences annuity payments at an advanced age. These types of contracts are intended to prevent people from outliving their savings. If the regulatory requirements are met, annuity payments can commence as late as age 85 without violating the required minimum distribution rules. The proposed regulations grant some additional flexibility for these contracts to allow for commutation or cash-out features. Such features were previously disallowed, but now can be available prior to the participant's required beginning date.

Other Topics of Interest

The proposed regulations specifically allow a beneficiary designation to be disregarded if the beneficiary in question submits a qualified disclaimer that meets applicable IRS guidelines (including the requirement that it be submitted within nine months of the participant's death). The proposed regulations also address the impact of state "simultaneous death" statutes, providing that a beneficiary who is treated as having predeceased the participant under the "simultaneous death" statute of the relevant state of residence will be disregarded when the beneficiaries applicable to the account are determined. For example, a state law may provide that a spouse who dies within 120 hours of a participant is deemed to have pre-deceased the participant.

Separately, the IRS has added a requirement that an insurance company providing an annuity contract to pay plan benefits must be licensed in the jurisdiction where the contract is sold.

Plan Amendments

The proposed regulations outline the topics that plan documents will need to address. The plan document:

- Must set forth the statutory rules of Section 401(a)(9), including the incidental death benefit requirement;
- Must provide that distributions will be made in accordance with Sections 1.401(a)(9)–1 through 1.401(a)(9)–9 of the Treasury Regulations;
- Must state that the provisions reflecting Section 401(a)(9) override any inconsistent distribution options; and
- Must address any other provisions required by the IRS to be included in the plan.

If the plan will apply an alternative timing rule instead of the regulatory default rule on one or more provisions (e.g., if a defined contribution plan provides for use of the 10-year rule in all cases in which the five-year rule is not required to apply, without allowing for life expectancy distributions) the plan document must identify the alternative rule to be applied. Similarly, if the plan will allow beneficiary elections between permissible rules, the plan must allow for such an election and identify the rule that will apply if a beneficiary fails to make an election.

According to the SECURE Act, amendments will be due by the end of the 2022 plan year. The regulations are proposed to take effect for 2022 and subsequent years. However, the SECURE Act changes to the required minimum distribution rules are already in operation. The IRS states in the proposed regulations that for 2021 and prior years, compliance with the existing regulations along with a reasonable interpretation of the SECURE Act is required. Compliance with the proposed regulations will be considered to satisfy this standard.

Excise Taxes

If a participant or beneficiary fails to take all or part of a required minimum distribution for a given year, the participant or beneficiary becomes subject to an excise tax of 50% of the missed required minimum distribution amount. The IRS can waive this tax if the failure occurred due to reasonable cause. In the proposed regulations, the IRS grants an automatic waiver if the eligible designated beneficiary of a defined contribution plan participant or IRA owner who died prior to the required beginning date missed amounts due under the life-expectancy rule, but had not affirmatively elected to use the life expectancy rule and instead complies with the 10-year rule. The IRS also makes an automatic waiver available to a beneficiary who missed the required minimum distribution due for the year of the participant's death, but who has taken that payment by the beneficiary's tax filing deadline for the beneficiary's taxable year beginning with or within the calendar year of the participant's or IRA owner's death. In other situations, the payee can continue to request a waiver by demonstrating reasonable error and reasonable efforts to remedy the failure.

The IRS also allows qualified retirement plans and 403(b) plans to correct failures to pay required minimum distributions via its Employee Plans Compliance Resolution System, and to apply to the IRS for excise tax waivers for affected participants and beneficiaries under the Voluntary Correction Program or the Audit Closing Agreement Program.

Rollover Regulations

The proposed rollover regulations update the rules for identifying distributions that are eligible for rollover. The updated regulations provide details on newer plan features (such as refunds of elective contributions within a specified time after automatic enrollment), expanded spousal rollover opportunities, and the ability of a beneficiary who is an individual or qualifying trust to roll a distribution from a plan to an inherited IRA. The new regulations also include details on calculating what portion of a distribution must be considered a required minimum distribution and ineligible for rollover.

In addition, the proposed regulations accommodate various exceptions to normal rollover deadlines. For example, the regulations address extended repayment opportunities for special withdrawals and distributions authorized by legislation relating to various natural disasters and the COVID-19 pandemic, as well as qualifying birth and adoption distributions allowed by the SECURE Act.

The proposed regulations also relocate the rules on rolling over plan loan offset amounts. Those rules reflect the extended deadline for rolling over the amount of a loan offset relating to a loan that defaulted due to plan termination or a participant's termination of employment.

Furthermore, the proposed regulations incorporate previous IRS guidance relating to determining which part of a distribution that includes both pre-tax and after-tax funds is taxable.

In addition, the IRS has incorporated the statutory rules on rolling over the proceeds of property distributed from a plan and then sold. The IRS has asked for additional comments on this issue.

Next Steps

The regulations are only proposed regulations, and there may be some changes made in the final version. However, the statutory changes reflected in the regulations are already in effect. Plan sponsors should discuss the available design choices and administrative logistics with their recordkeepers, and ensure they will have the appropriate amendment documentation approved before the end of the 2022 plan year.

As always, please feel free to contact a member of the Employee Benefits & Executive Compensation group at 585.232.6500, 716.853.1316, or visit www.hselaw.com or more information about the items discussed in this LEGALcurrents, or for assistance in other matters.