Flashpoint: The New RMD Proposed Regulations- And You Thought the Old Ones Were Confusing!

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The Treasury just released a long-awaited set of proposed regulations addressing the required minimum distribution ("RMD") rules under Internal Revenue Code (the "Code") §401(a)(9) (the "Proposal"). The Proposal, if finalized, would explain two of the most important RMD-related provisions of the Setting Every Community Up for Retirement Enhancement ("SECURE") Act: the delay in the required beginning date ("RBD") to age 72, and the 10-year limit on RMDs after death. In a sense, the regulations are welcome, because they answer many practitioner questions. On the other hand, the Proposal disappointed many practitioners in the way it handles certain post-mortem distributions.

The Treasury decided to completely rewrite and reformat all the RMD regulations—to the tune of 275 pages of information. In addition, the Proposal updates rollover regulations, which date back to 1995. While these changes are only proposed (and the Proposal does not provide that practitioners may rely on this guidance pending finalization), the planned effective date is January 1, 2022. Distributions taken in 2021 can be based on a reasonable interpretation of the law.

In this issue of the *Ferenczy FlashPoint*, we will explore some of the most notable issues in the Proposal as they relate to defined contribution plans. Future *FlashPoints* will discuss other issues.

Eligible Designated Beneficiaries

The SECURE Act added an important new definition to the RMD rules: eligible designated beneficiary ("EDB"). EDBs can continue to receive RMDs over their life expectancy. As discussed below, distributions to other recipients generally must be completed within 10 years.

An EDB is an individual beneficiary who, as of the date the participant died, is:

- The participant's surviving spouse;
- The employee's child who has not yet reached the "age of majority";
- "Disabled";

- “Chronically Ill”; or
- Not more than 10 years younger than the participant.

The Proposal defines the terms that we show in quotes. A child reaches the “age of majority” at age 21. Prior regulations, which were limited to specialized situations in defined benefit plans, allowed the age of majority to be as late as 26, if the child was a student.

The Proposal follows the restrictive Code §72(m)(7) definition of “Disability” as being unable to engage in substantial gainful activity. That criteria is hard to apply for children, and so the Proposal adds a secondary definition for beneficiaries under age 18: a Disability is “a medically determinable physical or mental impairment that results in marked and severe functional limitations, and that can be expected to result in death or to be of long-continued and indefinite duration.” A person who the Social Security Administration determines to be disabled also is considered to be Disabled for the EDB rules.

A beneficiary is “Chronically Ill” if a health care practitioner certifies that the beneficiary is unable to perform at least two activities of daily living (such as eating, toileting, and dressing) without substantial assistance for a lengthy, indefinite period.

The Proposal also provides that a beneficiary is not treated as Disabled or Chronically Ill unless the plan receives documentation of that status by October 31 of the year following the year of the employee’s death.

Note that the determination of the beneficiary’s status as Disabled or Chronically Ill is made as of the date the employee dies, even though the beneficiary may not be determined until later.

Example 1: Paul names his nephew, Nick, as beneficiary of his 401(k) account. Paul dies March 2, 2023. Nick is involved in an accident September 15, 2023, and as a result is chronically ill. Nick is not an EDB because he was not chronically ill when Paul died.

Example 2: Mary names her daughter, Diane, as beneficiary of her 403(b) account. When Mary dies at age 40, Diane is only 10 years old. At that time, she is not Disabled. However, five years later, Diane becomes Disabled. Diane is an EDB, because she is Mary’s child who has not reached the age of majority. Ten years after Diane turns 21, the plan must distribute the entire account to Diane. Had she been Disabled when Mary died, Diane would have been able to continue taking distributions throughout her life or life expectancy.

It is easy to overlook the fact that a beneficiary who is not more than 10 years younger than the employee is an EDB. This would cover most romantic relationships, as well as distributions to siblings or parents.

Distributions After Death

Death Before RBD

An EDB may take distributions over his/her life expectancy.

As under pre-SECURE rules, if the recipient is not a person who qualifies as a “designated beneficiary” (such as a charity or the employee’s estate) and the employee dies before the RBD, a 5-year rule applies. Under this rule, the entire account must be distributed by December 31 of the year that includes the fifth anniversary of the employee’s death.

If the person qualifies as a designated beneficiary, but is not an EDB, a new 10-year rule applies under SECURE if the employee dies before the RBD. In that situation, the entire account must be distributed by December 31 of the year that includes the 10th anniversary of the employee's death. So, while this beneficiary can no longer spread the benefit over his/her life expectancy, the 10-year rule is better than the pre-SECURE 5-year rule alternative.

The Proposal permits a plan to specify that the 10-year rule will apply to EDBs if the participant dies before the RBD. Alternatively, the plan may give the EDB the freedom to choose between the 10-year rule or the life expectancy rule.

Death After RBD

Perhaps the most controversial aspect of the Proposal relates to beneficiaries other than EDBs when the employee dies after the RBD. In that case, annual distributions must continue under the life expectancy rule as they would have pre-SECURE. However, the 10-year rule also applies, mandating that the entire account be distributed in the 10th year following death. Many were hoping, based on a reading of IRS Publication 590-B, that no RMDs would be required in years 1 through 9. (For what it's worth, our interpretation of the statute agrees with the Proposal, and we have consistently mentioned that in our speeches on the subject.)

Trusts as Beneficiaries

The Proposal includes important clarifications for trusts named as beneficiaries of retirement plan accounts. Previously, the regulations treated a trust as being, at most, one designated beneficiary, with an age equal to that of the oldest beneficiary of the trust. In Private Letter Rulings, the IRS had allowed a much more generous policy, particularly with regard to so-called "look-through" trusts. The Proposal codifies those trust rules, and thereby expands available estate planning techniques.

Waiver of Penalty Tax

A 50% penalty tax applies if a participant or beneficiary does not take an RMD. The RMD rules have always provided that the participant or his/her estate must take an RMD for the year of death in the same manner as if the participant lived until the end of the year—i.e., by December 31 of the year of death. If this did not occur, the penalty tax would apply.

The Proposal gives relief to this situation. Suppose an employee (or its estate) does not take an RMD in the year of death, and it remains undistributed by December 31. If the beneficiary takes the RMD no later than his or her tax return due date (with extensions), the penalty tax is automatically waived.

Final Thoughts

Of course, there is a lot more in the Proposal. We have not discussed the rules relating to defined benefit plans, special effective date provisions, the ability to disregard certain beneficiaries, and many other issues. More to come! And, naturally, we will review the new rules at this year's Pensions on Peachtree, April 25-26.

Our team is happy to work with you in making sure that the plans you serve comply with the RMD rules, or to correct situations where operations have fallen short. After all, we are your ERISA solution!

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