Required Minimum Distributions: Age Ain't Nothing but a Number…Unless the IRS is Asking

Adrienne Moore, Esq.

Bob is the owner of one of your best clients. You've known Bob for years. You attended his 65th birthday party last year. Every year, you send census information to Bob for verification and request the data you need to prepare his plan's filings. Bob's company has grown enough to warrant an HR director, and this year, Jan verifies the census data. When you get the census back from Jan, you realize that Bob's birth year has changed to 1946. You call Jan immediately to check on this and learn that it's just as you feared: Bob lies about his age and is actually 72. His diligent use of sunscreen lets him fool most people, but the IRS won't be so easily tricked.

You let Jan and Bob know that Bob should already be taking his required minimum distributions ("RMDs") and that his ownership status adds an important wrinkle (pardon the expression, Bob) to the issue. Because Bob is an owner, he cannot delay taking his RMDs until after retirement, even if the plan allows this for other participants. Participants who own more than 5% of the business must start taking RMDs at 70½, regardless of employment status. Failure to properly distribute the RMDs is an operational failure and violates Internal Revenue Code (the "Code") §401(a)(9). Left uncorrected, a potential outcome is disqualification of the plan. Additionally, the late distributions subject Bob to an astonishing 50% excise tax on the undistributed amounts.

Luckily, you now have Jan on your side, and the correction is a relatively simple one. The Employee Plans Compliance Resolution System allows for correction by distributing the RMDs, including earnings, from the date of failure through the date of the distribution. (See Revenue Procedure 2019-09 Appendix A.06.)

Determine the Missed Distributions

Jan and Bob confirm for you that Bob's correct date of birth is January 15, 1946. He turned 70 on January 15, 2016, and 70½ on July 15, 2016. Because Bob turned 70½ in 2016, his first RMD should have been taken by April 1, 2017. His second RMD should have been taken by December 31, 2017. This means that, if you are correcting the failure in November 2018, you will need to distribute amounts for two missed distributions and hurry up to take the third RMD by December 31, 2018.

The distribution amounts are determined by dividing the adjusted account balance on the applicable valuation date by the applicable distribution period. Now, let us explain in plain English.

What is the adjusted account balance? This is explained more fully in Treasury Regulation §1.401(a)(9)-5, Q&A-3. The adjusted account balance for defined contribution plans is the account balance as of the last valuation date in the calendar year immediately preceding the year for which the distribution is being taken. This plan is a calendar year plan, so the last valuation date of the preceding calendar year will always be December 31. Be careful! Even though Bob could have taken his first distribution by April 1, 2017, that distribution is actually related to the 2016 calendar year. The appropriate valuation date, then, is December 31, 2015. For Bob's 2017 RMD, the appropriate valuation date is December 31, 2016.

What is the applicable distribution period? The applicable distribution period is dictated by the IRS based on the participant's age as of his or her birthday in the calendar year for which the distribution is taken (not necessarily as of age 70½). It is a simplified version of a joint life expectancy calculation. You can find the Uniform Lifetime table in IRS Publication 590, Appendix B, Table III (found here). As we have now determined, Bob turned 70 on his birthday in 2016. Using the Uniform Lifetime table, the applicable distribution period for Bob's 2016 distribution was 27.4 years. For Bob's 2017 distribution, the applicable distribution period is for someone age 71, which was 26.5 years.

With this information, you are ready to calculate Bob's required minimum distributions for both years. Bob's account balance on December 31, 2015, was $191,800, giving an RMD for 2016 of $7,000. Bob's account balance for December 31, 2016, was $205,750. You must first reduce this amount for the missed distribution from 2016, giving an adjusted account balance of $198,750. With this adjusted account balance, Bob's RMD for 2017 was $7,500. Last, you must adjust for earnings. Bob's $7,000 distribution could have been taken any time before April 1, 2017. This means that you only need to calculate earnings on the $7,000 from April 1, 2017, through the date of actual distribution. For the $7,500 distribution that could have been taken any time before or on December 31, 2017, you will calculate the earnings from January 1, 2018, through the date of actual distribution. These earnings must be distributed simultaneously with the RMDs. For more information on earnings calculations, refer to our Solutions article on earnings.

Self-Correction or VCP?

You've calculated the amounts and successfully distributed the money to Bob. Do you need to do anything else, or is it enough to simply document the correction and move forward? Assuming this one failure affecting one participant is the only failure in an otherwise compliant plan, it would be safe to assume that the IRS would consider this an insignificant failure, and that, even if your distributions were outside of the two-year self-correction window, it would still be appropriate to self-correct the failure. In that instance, you would want to document the correction performed in a memo, along with exhibits that clearly show the calculations performed and proving the distributions actually took place. (You'll be glad you have this documentation five years from now, when you're trying to prove to the auditor how the failure was corrected.)

But what about the excise tax issue? As noted earlier, participants who fail to take timely distributions are subject to excise taxes under Code §4974 equal to 50% of the amount not distributed. The only way to get relief from the excise tax is either to request it through the Voluntary Correction Program ("VCP") with the IRS or for the individual to request a waiver from the IRS. For many plan sponsors, the cost of filing a VCP will be prohibitive and it will make more sense for the plan sponsor to reimburse the participant for those excise taxes. In this case, Bob's distributions total $14,500, meaning he is subject to a $7,250 excise tax. Effective as of January

2018, the filing fee for VCP ranges from $1,500 to $3,500. In this case, it could make sense to file with VCP and request relief. Of course, the IRS requires an explanation for why the participant should be granted relief, and lying about your age for years is unlikely to gain sympathy.

Quick Reminders

RMDs are not eligible for rollover. (Be sure that is correctly indicated on the related Form 1099-R, and it's always best to inform the participant of this, as well.) To avoid any issues going forward, assuming you have correct census information, it is a good practice to notify participants of the upcoming RMD when they attain age 70 and again six months later. Although they have until the April 1 following the calendar year in which they turn 70½, with proper notice, many participants may elect to take that first distribution before the end of the first year to better spread their tax burden. Finally, if a participant is not responsive to your requests, you may force out the RMD by the deadline without his or her consent.

FERENCZY
BENEFITS LAW CENTER
We are your ERISA solution™

Ilene Ferenczy • ilene@ferenczylaw.com | Alison Cohen • acohen@ferenczylaw.com
Adrienne Moore • amoore@ferenczylaw.com | Adriana Starr • astarr@ferenczylaw.com
Tia Thornton • tthornton@ferenczylaw.com | Leah Dean • ldean@ferenczylaw.com

2635 Century Parkway Suite 200, Atlanta, GA 30345
T 404.320.1100 | F 404.320.1105 | www.ferenczylaw.com