FEATURE

A Comprehensive Look at Intricate RMD Issues, Part 3

The third in a series of articles adds new questions and answers on the complex required minimum distribution rules.

BY WILLIAM C. GROSSMAN

Required minimum distributions (RMDs) remain a very specialized area within retirement plan administration — with their own depth of rules, exceptions to the rules and special acronyms and jargon.

This is the third article in a series on RMDs. Part 1 appeared in the Fall 2010 edition of *The ASPPA Journal, Plan Consultant's* predecessor; Part 2 appeared in the Spring 2014 issue of *Plan Consultant*. Note that this article begins with a long-overdue clarification of one point not correctly stated in Part 1; the remainder of this article is based on a variety of FAQs received at McKay Hochman.

WHEN IS A 5% OWNER "LOCKED-IN" AS SUCH FOR RMD PURPOSES?

Q: You say in the article that the 5% test date is the RBD (April 1); but it seems that the 5% test should not extend past Dec. 31 of the year in which the individual reaches age 70½. So, assuming a calendar year plan, wouldn't this necessarily mean that Dec. 31 of the year in which age 70½ is attained would be the cutoff date?

A: I agree. Code Section 401(a)(9)(C)(ii)(I) states: "except as provided in Section 409(d), in the case of an employee who is a 5-percent owner (as defined in section 416) *with respect to the plan year ending in the calendar year in which the employee attains age 70½* " (emphasis added). In the final RMD regulations of April 17, 2002, §1.401(a)(9)-2 Q&A 2(b) provides: "In the case of an employee who is a 5-percent owner, the term required beginning date means April 1 of the calendar year following the calendar year in which the employee attains age 70½." And §1.401(a)(9)-2 Q&A 2(c) of the regulations provides: "For purposes of section 401(a)(9), a 5-percent owner is an employee who is a 5-percent owner (as defined in section 416) with respect to the plan year ending in the calendar year in which the employee attains age 70½."

The following two Q&As demonstrate how this works.

Q: A client is currently a 5% owner through the family attribution rules because his wife owns the business. He is reaching the age of 70½ this year. But if his wife sells the business prior to Dec. 31, does that mean the client is not a 5% owner?

A: No. 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 locked in to being a 5% owner for RMD purposes. Thus, the RBD is April 1 after age 70½.

Q: 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 has recently sold all his ownership interest in the company. Must he continue taking RMDs?

A: Yes. The determination of who is a 5% owner for the purpose of the requirement to begin RMDs is determined by the ownership interest with respect to the plan year ending in the year the individual attains age 70½. A subsequent sale of the stock will not affect his status as a 5% owner.

Lastly, following is an example of the application of the Section 401(a)(9)(C)(ii)(I) rules.

Example: A 401(k)'s plan year is July 1, 2011 to June 30, 2012; a 5% owner reaches age 70½ on July 31, 2012. He sold his interest in the company on July 12, 2012. The plan year ending in the calendar year he turns 70½ is the plan year ending June 30, 2012. Since he was a 5% owner during the July 1, 2011 to June 30, 2012 plan year, his required beginning date is April 1, 2013, regardless of whether he sold his interest on July 10, 2012 (or on July 10, 2011).

MISSED RMDs

Q: We have a situation where an RMD was not distributed. Is it better to take the RMD now rather than not take it at all (since we are after April 1st, which is the first one the participant needed to take)?

A: Once it is discovered that an RMD was missed, the RMD, plus earnings, must be taken as soon as possible. Keep in mind that a plan is required to meet the Code Section 401(a)(9) requirement in order to maintain its status as a qualified plan. Thus, RMDs must be distributed. If this was caused by a plan sponsor/administrator error, the EPCRS VCP program, discussed below, is available and the plan sponsor is able to request that the 50% excise penalty be waived as part of the VCP filing.

TAXABLE YEAR FOR CORRECTIVE DISTRIBUTION OF MISSED RMDs

If a taxpayer misses an RMD, there is a 50% excise tax (a.k.a., a penalty) on the amount of the RMD that was not distributed. The 50% excise tax is paid by completing and filing IRS Form 5329. The 2012 Form 5329 instructions stipulate that the Form 5329 for the applicable tax year should accompany the tax return for the year that the penalty is due (unless you didn't file a tax return for that year, in which case the Form 5329 would be filed alone).

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Example

An individual with a traditional IRA attained age 70½ in 2011 and didn't take either his first distribution calendar year's RMD by April 1, 2012 or the second distribution calendar year's RMD by Dec. 31, 2012. Upon discovering this in February 2013, the individual should — as soon as possible — take the total of both missed RMDs plus earnings in order to correct the missed RMDs. The distribution of the two missed RMD amounts, although made in 2013, would be taxed in the applicable tax year.

To report and pay the missed RMDs, the individual would complete a Form 5329 (Part VIII) for 2012 to calculate the 50% penalty for 2012, and attach the 2012 Form 5329 to the 2012 Form 1040 or Form 1040NR.

To pay the 50% penalty for the 2011 missed RMD, the 2011 Form 5329 is to be completed and filed for the 2011 tax year with a Form 1040X.

Although the 2011 RMD could have been delayed until April 1, 2012, because it wasn't distributed in 2012, it is taxable in 2011 and must be included on the amended 2011 Form 1040X. According to the Form 5329 instructions, the 2012 RMD amount would be reported as taxable income on the 2012 income tax return. However, since at the time this article was written, we are well beyond the tax filing deadline, the 2012 return can be presumed to have been filed and a 1040X would now be needed to amend the 2012 return.

Keep in mind that if there is reasonable cause for the failure to take the RMD, the taxpayer may apply for a waiver of the penalty. According to the Form 5329 instructions (page 7):

"Waiver of tax. The IRS can waive part or all of this tax if you show that any shortfall in the amount of distributions was due to **reasonable error** and you are taking appropriate steps to **remedy the shortfall.** If you believe you qualify for this relief, **attach a statement of explanation** and **file Form 5329** as follows.

1. Complete lines 50 and 51 as instructed.
2. Enter **"RC"** and the **amount** you want waived **in parentheses** on the dotted line next to **line 52. Subtract this amount from the total shortfall** you figured without regard to the waiver, and enter the result on line 52.
3. Complete **line 53** as instructed. You must pay any tax due that is reported on line 53.

The IRS will review the information you provide and decide whether to grant your request for a waiver."

VCP FILING FOR MISSED RMDs

Q: If an employer uses the VCP for missed RMDs, does the individual also need to file Form 5329?

A: It depends on how the employer completed the VCP filing. Under the VCP, the employer may check off a box, which is on Appendix C, Part II, Schedule 8, to apply to the IRS (as part of the VCP application process) for a waiver of the 50% excise tax for each of the individuals who missed an RMD. If anyone subject to the excise tax is either an owner-employee as defined in Code Section 401(c)(3) or a 10% owner of a corporation, the plan sponsor must provide an explanation in support of the request.

If the employer does not check the box requesting the excise tax to be waived, then the individual would have to file the Form 5329 and either pay the 50% excise tax or request a waiver of it, if there is a reasonable cause.

The fee for this type of VCP submission is $500, provided that the missed RMDs are the only plan failure that exists.

NON-5% OWNER WORKING AFTER AGE 70½ AND A PLAN TERMINATION

Q. The RBD for non-5% owners in a plan is defined as April 1 of the year following the later of either the year age 70½ is reached or the year of retirement. The employer terminates the plan on Sept. 30, 2013. Must we pay RMDs to the non-5% owners who are over age 70½ and continue to work after the plan is terminated?

A. No. When the plan terminates everyone will be required to receive a distribution of their balance in the plan. The non-5% owners over age 70½ who are continuing to work did not meet the plan's definition of RBD at the time the plan was terminated. Thus, those individuals will be paid their entire plan balance and it will all be an eligible rollover distribution.

If such an individual rolls it into an IRA, for example on Nov. 1, 2013, the first RMD from the IRA will be due by Dec. 31, 2014, based on the balance in the IRA on Dec. 31, 2013.

401(k) ROTH AND RMDs

Q: I have a 5% owner who turned 70½ and has already taken her RMD from pretax sources for 2013, but also has a 401(k) Roth source. When

> "If a taxpayer misses an RMD, there is a 50% excise tax (a.k.a., a penalty) on the amount of the RMD that was not distributed."

she takes the Roth RMD, does the five-year rule apply for it not to be taxable? Going forward, if she took an in-service withdrawal (allowed in this plan) of 100% of her 401(k) Roth source and rolled it into a Roth IRA, does she have to take the RMD at that time?

A: The five-year rule for tax-free earnings applies to RMDs from a Roth 401(k) account. She can take the RMD entirely from her pretax source (which she already did for 2013). If pretax account is not enough to satisfy the RMD, then she will need to take a withdrawal from the Roth source to satisfy the RMD.

If the RMD for the year is already taken from pretax sources, then she can take an in-service distribution and directly roll the 401(k) Roth into a Roth IRA. Roth IRAs are not subject to RMDs while the IRA owner is alive. After death, the beneficiary is subject to the RMD rules.

Before rolling into a Roth IRA, the individual should understand the differences between the 401(k) Roth five-year clock and the Roth IRA five-year clock.

If she never had a Roth IRA before, then she would have to start counting the five years to satisfy tax-free earnings in the Roth IRA with the 2013 rollover of 401(k) Roth funds. Note that the Roth IRA five-year clock starts with the first Roth IRA ever opened by the individual.

If the Roth IRA five-year clock had not been satisfied, the time towards the five years satisfied in the 401(k) would be lost because the Roth IRA five-year clock is separate — time spent satisfying the 401(k) Roth five-year clock does not count towards satisfying the Roth IRA clock.

RMDs AND THE TOP-HEAVY 5-YEAR LOOK-BACK RULE

Q: Are RMDs paid to 5% owners who are still working required to be included as an in-service distribution for the five-year look-back rule when performing top-heavy testing?

A: Yes. As long as an individual worked for at least an hour during the look-back year, the five-year look-back rule for adding back in-service distributions applies. For someone who is working, an RMD would be a form of in-service distribution subject to the five-year look-back.

Since 5% owners must take an RMD as of April 1 after the year in which age 70½ is reached, the 5% owner who is still working and taking RMDs must have the RMD added back to the determination date balance for the top-heavy test.

If a non-5% owner is taking in-service distributions while still working at age 70½ or beyond, these amounts would also be added back. In addition, in the year the non-5% owner severs from service after age 70½, if he or she takes an RMD in that year, since he or she also worked in that year, the RMD would be added back.

CHANGING RMD ELECTION WHILE WORKING AND NOT SUBJECT TO RMDs

Q: May a person who is over 70½, not a 5% owner, and still working change his or her RMD election from year to year, take a distribution one year, elect to defer the following year, and then elect to take the RMD again in the third year?

A: If the plan's definition of RBD for non-5% owners is the later of April 1 after the later of attainment of age 70½ or retirement, then non-5% owners who are working beyond age 70½ have not yet reached their RBD. Thus, these individuals are not subject to RMDs.

If the plan permits in-service distributions, there is nothing wrong with a non-5% owner arranging an in-service distribution to be calculated using the RMD formula. It is not an RMD. As such, the non-5% owner may change the amount of the in-service distribution or stop it. The individual is not waiving or deferring an RMD since the individual is not required to take an RMD until he or she reaches the RBD. PC

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