

Federal Update 2004-20

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Impact of New Minimum Distribution Regulation on Governmental Defined Benefit Plans

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On June 14, 2004, Treasury and the IRS issued a final regulation regarding minimum distribution rules (MDRs) for defined benefit plans and annuity products purchased with account balances in other types of qualified retirement plans and IRAs. The MDRs, located in Code §401(a)(9), specify how and when payments from various retirement programs must be made. In drafting the regulations, Treasury and IRS set out a policy that such payments must be either nonincreasing or increasing only as the regulations specify. This policy creates problems for state and local governments which have adopted justifiable benefit increases, some of which do not fit into Treasury's and IRS' narrow interpretations. The problems were identified during review of the temporary regulation issued by Treasury and IRS on April 17, 2002. Areas of conflict include COLAs and annuity distribution options. NCTR and others communicated their concerns to Treasury and IRS.

This memo reviews the rules in the final regulation insofar as they affect governmental defined benefit plans only. Please note that, due to the pressure of time, this is not intended as an exhaustive analysis of the final regulation.

1. Time Line

- a. IRC §401(a)(9) was substantially changed in the first half of 1980's.
- b. Proposed regulations interpreting IRC §401(a)(9), as amended were published on July 27, 1987.
- c. Regulations were "reproposed" on January 27, 2001.
- d. Final regulations were published on April 17, 2002 except the defined benefit regulation was issued as a temporary regulation to apply commencing in the 2003 calendar year.
- e. Notice 2003-2 was subsequently issued allowing governmental defined benefit plans to satisfy "a reasonable and good faith interpretation" of IRC §401(a)(9) "pending the issuance of further regulations".

f. The final regulation concerning minimum distributions from defined benefit plans and annuity contracts has just been issued, effective June 15, 2004.

2. Bottom Line Impact on Governmental Defined Benefit Plans

a. General Rule - As a general matter, annuity payments under a governmental defined benefit plan must satisfy the final regulation, viz., Treas. Reg. §1.401(a)(9)-6 (Required minimum distributions for defined benefit plans and annuity contracts).

b. Grandfathering for Governmental Plans - However, any “annuity distribution option” provided under the terms of a governmental defined benefit plan in effect as of April 17, 2002 will satisfy IRC §401(a)(9), provided “the distribution option satisfies [IRC §401(a)(9)] based on a reasonable and good faith interpretation of the provisions of [IRC §401(a)(9)].”

c. Temporary Relief for Non-Grandfathered Benefits - Further, with respect to any non-grandfathered distributions for calendar years 2003, 2004 and 2005, such distributions which do not satisfy the final regulation will still be okay provided, again, “the distribution option satisfies [IRC §401(a)(9)] based on a reasonable and good faith interpretation of the provisions of [IRC §401(a)(9)].”

d. Further Extension of Temporary Relief for Non-Grandfathered Benefits - In the case of governmental plans, the temporary relief for non-grandfathered distributions extends “to the end of the calendar year that contains the 90th day after the opening of the first legislative session of the legislative body with the authority to amend the plan that begins on or after June 15, 2004, if such 90th day is later than December 31, 2005.”

e. No Protection or Relief - No grandfathering protection and no temporary relief is provided for distribution options which cannot be justified by a reasonable and good faith interpretation of IRC §401(a)(9).

f. Amendments Made between Effective Date of Grandfather and Effective Date of Final Regulation – Any amendment made on or after April 17, 2002 and before June 15, 2004 must be brought into compliance by the end of the temporary relief period discussed in c and d above. Also amendments made during this period must be considered to determine whether they have jeopardized the plan’s grandfathering. Once the temporary relief expires for benefits paid on the basis of non-grandfathered amendments, non-grandfathered benefits must comply with the final regulation.

g. Post-June 14, 2004 Amendments - Any amendments made on or after June 15, 2004 must comply with the final regulation. In addition, the amendments must be carefully considered to prevent loss of grandfathered status. It is not clear at this time what would cause loss of grandfathering.

3. Features Considered Non-Problematic under Temporary Rule

The following distribution features did not appear problematic under the proposed or temporary regulation and continue to be non-problematic under the final regulation:

- a. Single life annuity to the member with no survivor benefit;
- b. Joint and survivor annuity where the spouse is the survivor (provided the survivor benefit is not greater than 100% of the member's benefit);
- c. Joint and survivor annuity where the survivor is a non-spouse and the age difference between the member and the survivor is no greater than 10 years (provided the survivor benefit is not greater than 100% of the member's benefit);
- d. Annuities with period certain protection (provided certain restrictions on length of guaranteed period are not exceeded);
- e. COLAs where the annual percentage increase does not exceed the annual increase in certain Bureau of Labor Statistics ("BLS") consumer price indexes;
- f. Increases in benefits pursuant to a plan amendment;
- g. Ancillary benefits payable to a survivor upon the death of a member in retirement (provided the benefits are not part of the member's benefit being annuitized).

4. Features Considered Problematic under the Temporary Rule

The following issue areas were raised as concerns during the process leading up to the issuance of the final regulation. The outcome is discussed in 5-8 below.

- a. Other COLAs/purchasing power protection provisions/thirteenth checks;
- b. Restrictions on joint and survivor annuities where the survivor is a non-spouse more than 10 years younger than the member;
- c. Other annuities with other types of survivor benefits;
- d. Annuities that change upon certain changes in circumstances.

5. COLA Changes

a. Increase Pursuant to an Index - The temporary regulation barred any increase via a cost of living adjustment unless the increase is pursuant to 1) an annual percentage increase that does not exceed the annual percentage increase in a cost-of-living index that is based on prices of all items and issued by the Bureau of Labor Statistics (BLS) or 2) a plan amendment. The final regulation retains these exceptions and expands the types of "indexes" which may be used in providing COLAs have been expanded so that the permitted indexed-based percentage increase can be up to:

(i) the percentage increase in a BLS index (index for specific population or geographic area can be used);

(ii) the percentage increase in a BLS index or a fixed percentage, whichever is less. However, the fixed percentage can exceed the BLS percentage increase, provided it does not exceed the BLS increase for that year plus the cumulative excesses in the increase of the BLS index over the fixed index for prior years;

(iii) a percentage adjustment based upon an increase in the compensation for the position held by the member at retirement.

b. Flat Percentage Increase that Cannot Exceed Index - The final regulation allows for a percentage increase at a specified time (e.g. at specific ages). However, the increase may not exceed the cumulative permissible increase in the permissible index since the annuity start date or the date of the most recent previous percentage increase, if later.

c. Flat Percentage Increase of Not Greater than 5% - In a later part, the final regulation also provides that, in the case of an annuity provided by a IRC §401(a) defined benefit plan, payments may be increased by a constant percentage applied not less frequently than annually at a rate not to exceed 5% per year.

d. Increase Based on Actuarial Gain - That later part also provides that, in the case of an annuity provided by a IRC §401(a) defined benefit plan, an increase can permissibly result from dividend payments or other payments that result from actuarial gains but only if

(i) the actuarial gain is measured no less frequently than annually;

(ii) the payment is either made no later than the year following the year in which the actuarial experience is measured or paid in the same form as the payment of the annuity over the remaining period of the annuity;

(iii) the actuarial gain taken into account is limited to the actuarial gain from investment experience;

(iv) the assumed interest used to calculate such actuarial gains is not less than 3%; and

(v) the payments are not increasing as a constant percentage.

e. Non-Conforming COLAs - Increases paid pursuant to COLAs/purchasing power protection provisions/thirteenth checks provisions not coming within any of the foregoing will only be permissible, if at all, under the grandfather/temporary relief discussed above.

6. Restrictions on J&S Annuity With Younger Non-Spouse Beneficiary

The 1987 and 2001 proposed regulations and the temporary regulation had a chart which barred the payment of a survivor portion of a joint and survivor annuity which exceeded a certain percentage of the member's annuity, where the member and the beneficiary differed in age by more than 10 years. The applicable limit depended upon the difference between the age of the member and the age of the beneficiary. For example, under the chart, a surviving beneficiary who was 20 years younger than the member could not receive a survivor benefit which was greater than 73% of the member's benefit.

This chart was based upon the assumption that the member was retiring at age 70. The final regulation now takes into account the fact that employees do retire at ages much earlier than age 70.

In determining the difference in age between the member and the survivor, the final regulation now allows for a deduction for the number of years by which the member's age at his/her birthday in the calendar year of retirement precedes age 70.

For example, suppose the member will attain age 55 in the calendar year of retirement and the beneficiary is age 35. Under the proposed and temporary regulations, the limit for beneficiaries 20 years younger had to be used. Under the final regulation, 15 years can be deducted from the difference in their ages to reflect the fact that the member is retiring 15 years prior to age 70. As a result, the member and beneficiary are treated as having only a 5 year age difference for the purposes of the chart.

Those systems which have previously installed the chart into their benefits calculations have an opportunity to liberalize the availability of options for affected members.

7. Other Annuities with Other Types of Survivor Benefits

a. In the case of an annuity provided by a IRC §401(a) defined benefit plan, the final regulation appears to allow for a final payment to a survivor that does not exceed the actuarial present value of the member's accrued benefit at the time of retirement over the total payments made before the death of the member (a "declining reserve annuity").

b. Otherwise the final regulation appears to bar the payment of any form of survivor benefit which is greater than the benefit being paid prior to the member's death (unless the payment is permitted under one of the exceptions provided in the final regulation, e.g., a permitted COLA). This is the so-called "non-increasing benefit" rule.

c. Some period certain annuities could be problematic depending upon the age of the member at retirement.

8. Annuities that Change with Change in Circumstances

a. The final regulation continues to allow for subsequent increase in a member's annuity to the extent that a reduction was necessary to provide a survivor benefit. However, this only

applies where the survivor has died or is no longer the member's beneficiary "pursuant to a qualified domestic relations order". (N.B., it is not clear whether the quoted language is to be taken literally; the preamble (p. 7) to the final regulation speaks of allowing "a pop-up in payments in the event of a divorce".)

b. The final regulation continues to allow a beneficiary to convert the survivor portion of the benefit to a lump sum. However, this appears only applicable where the conversion is at the beneficiary's election.

c. Subject to certain conditions, a "period certain only annuity" can be changed at any time.

d. Subject to certain conditions, an annuity can be changed to a qualified joint and survivor annuity upon marriage in retirement.

e. Certain payments to "children" can be considered payments to the spouse for the purposes of the final regulation, provided the payments revert to the spouse when "childhood" ceases. For these purposes, a disabled child is considered a "child" so long as the disability continues.

f. N.B., if a system provides a optional form of retirement which is not specifically sanctioned in the final regulation, that option is only be permitted where grandfathered.