STIFEL

Retirement Plans Quarterly

Second Quarter 2017

MISSED REQUIRED MINIMUM DISTRIBUTIONS

Investors who reach the age of 70½ must withdraw Required Minimum Distributions (RMDs) from traditional/SEP/SIMPLE IRAs and 401(k)s by the applicable deadline, which is normally the end of each calendar year.

According to IRS Publication 590, a missed RMD is referred to as an “excess accumulation.” The failure to take all or part of an RMD by the applicable deadline results in a penalty of 50% of the missed RMD.

If the required amount was not distributed or an RMD is completely missed, an IRA holder must take appropriate action to correct the problem. In the case of reasonable error, and the IRA holder is taking the necessary steps to remedy the insufficient distribution, a request may be made to waive the penalty. In this scenario, the IRA holder must write a statement of explanation and complete Form 5329 (Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts) for each year in which there was a missed RMD or shortfall. Note that a Private Letter Ruling (PLR) is not required for this type of penalty waiver, which means there is no filing fee for requesting a waiver of the RMD penalty. Under this procedure, with the help of a tax consultant, an individual should explain how the error occurred, that it was corrected, and the steps that were taken to guarantee that the oversight will not happen again. The letter, along with Form 5329, must be filed with the IRS.

Upon review of the information, the IRS will render a decision to either grant or deny the request for waiver of the penalty.

It is highly recommended, if any amount of an RMD has been missed, that IRA holders work with their tax advisor and follow the proper procedures for an acceptable solution.

NON-SPOUSE BENEFICIARIES OF QRPs ALLOWED DIRECT ROLLOVERS TO INHERITED IRAs

Are you aware that a non-spouse beneficiary, such as a child, grandchild, brother, or sister, who inherits the assets from a deceased Qualified Retirement Plan (QRP) participant, is allowed to roll the assets directly into a Traditional Inherited Beneficiary IRA, or convert those assets to a Roth Inherited Beneficiary IRA?

At one time, only spouse beneficiaries were permitted to roll over inherited QRP assets into their own IRA or into an inherited IRA. However, for several years now (enacted under the Pension Protection Act of 2006 (PPA ’06) and clarified in IRS Notice 2008-30), the assets in deceased participants’ QRPs have been allowed to directly roll into inherited beneficiary IRAs through trustee-to-trustee transfers or Roth conversions. While a transfer to an inherited Traditional IRA may be a non-taxable event, conversions to inherited Roth IRAs are different, as all pre-tax amounts become taxable to the beneficiary and reported as ordinary income. Note that although the transfer is technically called a “direct rollover,” constructive receipt (checks payable to a beneficiary) must be avoided, as rollovers to IRAs by non-spouse beneficiaries are not permitted. Constructive receipt may result in the loss of the benefit and immediate taxation.

IRA Rules Must Be Followed

Once the assets are received into an inherited beneficiary IRA, all Required Minimum Distribution (RMD) rules apply. Generally, if a QRP participant was taking RMDs prior to death, or had reached the plan’s Required Beginning Date for taking distributions, the RMD from the QRP for the year of death must be satisfied based on the deceased owner’s age. However, for each subsequent year, RMDs must be taken from the inherited IRA by December 31 and calculated based on the beneficiary’s single life expectancy, determined by referencing the IRS Single Life Expectancy Table.

If the deceased QRP participant was under the age of 70½ at the time of death, the five-year RMD option may also be selected in the IRA. With this option, the entire balance of the inherited IRA must be distributed before the end of the fifth year following the year of the QRP owner’s death.

2nd Quarter 2017

Inherited Beneficiary IRA Advantages

By taking a direct rollover, a non-spouse beneficiary can:

- Possibly defer taxes for a longer period of time – Some QRPs may require a quicker payout period for non-spouse beneficiaries and life expectancy RMDs may not be available, thus resulting in immediate taxation.
- Convert to a Roth beneficiary IRA – RMDs must be taken from inherited Roth IRAs. However, by converting and paying any tax due now on the current value, since smaller RMDs are taken during the earlier years, potentially larger tax-free growth continues to accumulate.
- Preserve the Stretch IRA strategy – Once the assets are in an inherited beneficiary IRA, the beneficiary is allowed to name his or her own beneficiaries, if the IRA custodian permits. If the beneficiary of the inherited IRA dies before reaching his or her full life expectancy, the IRA assets can continue to be paid to the successor beneficiary over the remaining distribution period of the deceased beneficiary.

Conclusion

Whether it's for the ease of management or the possibility of "stretching" RMDs over a longer period of time, beneficiaries of QRPs may want to consider a direct rollover to an inherited beneficiary IRA.

Note that this information is for educational purposes only and it is always recommended that an individual seek the aid of a competent tax advisor or tax attorney before final decisions are made.

PRE-TAX VERSUS AFTER-TAX LUMP-SUM DISTRIBUTIONS FROM QUALIFIED RETIREMENT PLANS

A Qualified Retirement Plan (QRP) participant, upon a triggering event, is able to roll over assets into a traditional or Roth IRA. However, prior to January 1, 2015, if a participant's plan balance included both after-tax and pre-tax assets, then each distribution from the account was required to include a pro rata share of both after-tax and pre-tax amounts. If the distribution was rolled into an IRA, it was required that the after-tax portion be tracked for the life of the IRA, by the IRA owner and beneficiaries. Historically, a single distribution could not be split with the pre-tax amount going into a traditional IRA and after-tax portion into a Roth IRA. This requirement was a burden for plan participants and their CPAs.

IRS Notice 2014-54

In late 2014, the IRS released Notice 2014-54 (effective January 1, 2015), which states that a plan participant may take a lump-sum distribution and separate pre-tax and after-tax dollars and deposit them respectively into a traditional IRA and Roth IRA.

Basically, this allows QRP participants to isolate after-tax amounts and make tax-free Roth IRA rollovers directly from their plan, while rolling the pre-tax amounts directly to their traditional IRA. According to language found in the notice:

If the direct rollover is to two or more plans, then the recipient can select how the pre-tax amount is allocated among these plans. To make this selection, the recipient must inform the plan administrator of the allocation prior to the time of the direct rollovers.

Timing Is Everything

Another component of the guidance is the number of distributions from the plan. To achieve the separation of pre- and after-tax dollars, the distributions must be initiated at the same time:

> *… all disbursements of benefits from the plan to the recipient that are scheduled to be made at the same time (disregarding differences due to reasonable delays to facilitate plan administration) are treated as a single distribution without regard to whether the recipient has directed that the disbursements be made to a single destination or multiple destinations.*

Partial Distributions

If a plan participant is considering a partial distribution of only the after-tax portion of the assets, the pro rata rule will still apply. The following example from IRS Notice 2014-54 helps to illustrate this practice:

> *An employee's qualified plan balance consists of $200,000 of pre-tax amounts and $50,000 of after-tax amounts. The employee separates from service and requests a distribution of $100,000. The pre-tax amount of the distribution is $80,000 (four-fifths) and the after-tax amount of the distribution is $20,000 (one-fifth). The employee is permitted to allocate the $80,000 that consists entirely of pre-tax amounts to the traditional IRA so that the $20,000 rolled over to the Roth IRA consists entirely of after-tax amounts.*

Pre-1987 Rule

Another point to consider is, if the after-tax assets represent pre-1987 contributions to the plan and separate accounting by the plan administer occurred, a participant may request a separate distribution of only these assets and they would not be subject to the pro rata rule. If this is the case, the individual could take a distribution of the assets or roll the assets into a Roth IRA.

Final Comment

The ability to separate pre-tax and after-tax assets for rollover purposes is good news for QRP participants with after-tax dollars in their plans. Why? Instead of being caught with a lifetime of pro rata tracking of after-tax dollars inside a traditional IRA, they now have the ability to indicate where the pre- and after-tax dollars will roll if done properly and take advantage of a Roth IRA.

IRS Notice 2014-54 can be reviewed in its entirety at this website: http://www.irs.gov/pub/irs-drop/n-14-54.pdf

WHAT HAPPENS TO A RETIREMENT PLAN WHEN A COMPANY IS SOLD

When a company is sold, what to do with the retirement plan is sometimes an afterthought. But, if the acquiring company already has a retirement plan, certain items might need to be addressed before the company purchase happens. In general, the following options are available when both the buyer and seller have a retirement plan:

- Maintain multiple plans
- Merge the plans
- Terminate one or more plans
- Freeze one or more plans

A lot depends on whether the sale of the company is an asset or a stock sale. An asset sale occurs when the buyer purchases all or a portion of the seller's assets. Asset sales can result in a termination of employment, which in turn triggers the right of a distribution from most retirement plans. Because of this, the buyer generally has three options with regards to the plan. One, the buyer can agree to continue the retirement plan. Two, the buyer can merge the plan into its own plan, if such a plan exists. And three, the buyer can terminate the plan.

If the buyer does not want the employees taking distributions from the retirement plan as a result of the asset sale, it must continue the plan or merge it into its own plan. The decision to continue or merge the plan must be effective on or before the date of the sale of the company. Continuing the plan when one already exists can make sense, especially when the two plans cover two separate demographics. However, maintaining two plans at the same time can be costly. In the case where most or all of the employees are not retained after the sale, a termination of the plan is common.

In an asset sale, if the buyer wishes to merge plans, it is not required to recognize the employees' service earned with the prior employer for either vesting purposes or plan eligibility. However, the acquiring company may voluntarily amend its plan document to accept the prior service for vesting and/or eligibility. That said, a participant merging into the new plan cannot lose any vesting as a result of the merger, even if the new company's vesting provisions are less generous.

A stock sale occurs when a buyer purchases all of the corporate stock, which effectively replaces the existing owners of the corporation. The new owner becomes the holder of all assets, liabilities, and employment contracts. If both the purchasing and selling company have separate retirement plans that allow employee deferrals (e.g., 401(k) plans), it might be necessary to terminate the seller's plan before the acquisition is effective. The reason for this is that if a retirement plan with employee deferrals is terminated, an employer may not have another retirement plan with employee deferrals until at least 12 months after all assets have been distributed. Thusly, the preexistence of the buyer's 401(k) plan would immediately violate this rule. In these situations, it is usually best to arrange for the seller to terminate the plan before the effective date of the acquisition.

A merger of plans is also possible in a stock sale. A plan merger occurs when two or more plans are combined into the existing plan of the ongoing company. If the buyer doesn't wish to merge the plans but wants the acquired employees to participate in the buyer's plan, it can become very complicated. In this situation, the seller's plan must be terminated but the newly acquired employees must wait 12 months from when the assets are distributed before they can participate in the new plan. Or, another option is to freeze the seller's plan so that no new contributions are allowed. In a frozen plan, distributions may be made in the events of termination of service, retirement, death, or disability. In-service withdrawals must also be permitted as well if they were allowed before the plan was frozen.

Unlike the asset sale where it is optional to recognize prior service, stock sales require all service with the prior employer to be counted for vesting and eligibility purposes. This is because employees do not technically terminate employment in a stock sale, so there is not an interruption of continuous service for retirement plan purposes.

With all plan mergers, it is required that all plans meet the same coverage requirements that applied before the plan merger. There is a grace period given, however, that extends until the close of the plan year following the plan year in which the acquisition occurred. Essentially, the employees that are acquired may be ignored when demonstrating compliance with minimum coverage requirements from Internal Revenue Code (IRC) 410(b) during the grace period. The first plan year after the grace period must provide sufficient coverage as determined by IRC 410(b).

If there are outstanding loans in the seller's plan, the loans may also be merged into the buyer's plan, but a plan amendment may be necessary if loans were not previously allowed in the surviving plan. This is not required as loans are not considered a protected benefit but loan repayments that are not made will result in adverse tax consequences for the borrowing participants, which is why some acquiring companies choose to add loans to their plan.

There are many options and factors to be considered when a company with a retirement plan is acquired, as it can be an incredibly complex situation. While Stifel advisors can assist in this area with the investments or termed participant rollovers, please consult an ERISA attorney for legal counsel.

WHEN TO MAKE CHANGES TO A PLAN DOCUMENT

Qualified retirement plans are required to establish a plan document, relevant to customize the Basic Plan Document, to provide guidelines for the operation of a plan. The different types of qualified retirement plans may include profit sharing, 401(k), money purchase, defined benefit, 403(b), and 457(b) plans. Non-qualified retirement plans have some flexibility for this requirement, but it is advisable to establish and maintain a plan document to ensure the plan is operating consistently and fairly on behalf of the plan participants. A few common non-qualified retirement plans are 457(f) and deferred compensation plans.

Typically, there are three scenarios in which an adjustment to a plan document must be made. Certain rules pertaining to the protection of benefits and nondiscrimination place restrictions on plan sponsors for purposes of amending a retirement plan, which will be discussed in greater detail. ERISA requires two things with regard to amending a qualified retirement plan: there must be a procedure for 1) amending the plan and 2) identifying the individuals who have authority to amend the plan.

The first scenario for amending a plan is driven by the IRS and requires that all plan sponsors maintaining a qualified retirement plan using a pre-approved document, whether prototype or volume-submitter, must restate their document every six years. Individually designed, or attorney-drafted, plan documents have a separate five-year restatement cycle to which they must adhere. The required restatement has been mandated to ensure that remedial and discretionary amendments are incorporated into the complete plan document. Remedial amendments conform the plan to the legal requirements that have been reviewed and approved by the IRS in the interim since the last restatement period. The restatement is titled using the last bit of legislation that was passed for retirement plans. The Pension Protection Act (PPA) was the last restatement cycle required and should have been completed by April 30, 2016; thus, employers needed to sign the restated document by that deadline.

The second scenario arises when there are changes to the qualification rules that apply to retirement plans. A good example of this scenario is the Worker, Retiree, and Employer Recovery Act of 2008 (WRERA), which required that retirement plans include the waiver of the 2009 required minimum distributions. Generally, remedial amendments must be adopted before the end of the applicable amendment period; however, a qualification rule amendment may need to be adopted earlier if the provisions must be conformed to retirement plans sooner.

The third scenario occurs when the plan sponsor changes how the plan operates and must adjust the governing plan document according to the discretionary amendment. A good example of this scenario is adding a match contribution to a 401(k) plan. The plan document must be amended to reflect the addition of a match contribution, whether discretionary or a stated formula, and if there are special requirements to share in the allocation of the contributions. Excluding a certain class of employees, such as leased employees, from participating in the plan is another example of a discretionary amendment.

In adjusting the document that governs the operation of a qualified retirement plan, there are some items that should be considered in advance of implementing such changes. Serious considerations should be made as to the administrative burdens that could be incurred as a result of implementing an operational change. If the plan sponsor decides that a plan feature is difficult to administer, it is possible the provision cannot be removed if it is a protected benefit. What does that mean?

Protected benefits exist to ensure that a participant's accrued benefit is not reduced or eliminated as a result of a plan amendment. The prohibition of reducing accrued benefits is known as the anti-cutback rule. This rule is easy to conceptualize when a plan amendment attempts to reduce an individual's account balance or accrued benefit. It is a bit more subtle when an amendment is made mid-year and affects the allocation of employer contributions for a specific plan year in a defined contribution plan, or the benefit accrued for a plan year in a defined benefit plan. A good example of a protected benefit could be amending a plan's vesting schedule to provide a more strict schedule. Since the prior vesting schedule was more lenient, thus providing a higher account balance or accrued benefit to plan participants, the new vesting schedule can only apply to future contributions.

The anti-cutback rule was created to protect optional forms of benefit, early retirement benefits, and retirement-type subsidies with regard to accrued benefits. An optional form of benefit is the form or timing of distributions under a retirement plan. A few common examples of this are forms of distribution payment, timing of the payment following separation of service, timing of payment while in-service, and the medium of payment. For clarification on what constitutes a protected benefit, it is best to discuss the targeted form of benefit with a third-party administrator or actuary for confirmation.

Another consideration for plan document changes involves the requirements of disclosures and notices to plan participants and beneficiaries. Automatic Contribution Arrangement (ACA) notices and Safe Harbor Notices are due to plan participants in advance of the effective date of the amendment. Certain disclosures must be provided to terminated participants with balances, which can prove challenging if a last known address is no longer valid. As a result, time should be built in to allow for notifications prior to implementation of a new plan provision.

Each plan amendment will have a deadline for execution. Typically, amendments for discretionary changes must be implemented by the last day of the plan year in which the change became effective. There are certain exceptions that could apply, so plan sponsors should consult with their plan administrator or tax advisor before moving forward with a plan amendment. Ultimately, plan design can be tricky and the professionals that specialize in this aspect of plan administration should be consulted when a change to the operation of a plan is contemplated.

STIFEL

Stifel, Nicolaus & Company, Incorporated | Member SIPC & NYSE | www.stifel.com
One Financial Plaza | 501 North Broadway | St. Louis, Missouri 63102