



irs further clarifies new beneficiary rollover rules

MSK Client Alert

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The IRS has responded to some of the negative reaction it received with respect to recently issued guidance on the new rules allowing non-spouse beneficiaries to make rollovers to IRAs.

The criticisms and the IRS response relate to two issues:

- (1) Was the statute, when originally enacted last year, intended to guarantee all non-spouse beneficiaries the right to make an IRA rollover regardless of the provisions of the distributing plan?
- (2) Do non-spouse beneficiaries who make a rollover to an IRA have the right to stretch out distributions over the beneficiary's life expectancy, even if the distributing plan would not have provided this right.

Rollover rights

On the first issue, the IRS stated in the issue of Employee Plans News issued February 13, 2007, that "a plan may, but is not required to" offer a direct rollover option to non-spouse beneficiaries. This means that there is no guaranteed right of a non-spouse beneficiary to make a rollover.

This is consistent with the IRS previously stated position that the distributing plan must be amended to provide for rollovers by non-spouse beneficiaries and that the amendment was optional, not mandatory. This is not surprising since these rules were not made a requirement for plan qualification and since all direct rollover provisions have to be set forth in the plan document. It seems likely that nearly all plans will eventually make this amendment, since it costs the plan sponsor nothing and will significantly help certain participants. However, there is no guarantee. In addition, the amendment presumably can be made up until the deadline for plan amendments due for the Pension Protection Act of 2006 (currently 2009 and subject to IRS extension) and be made retroactive to January 1, 2007.

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Minimum distributions

The second issue involved a provision of the original IRS guidance that says:

"The rules for determining the required minimum distributions under the plan with respect to the non-spouse beneficiary also apply under the IRA. Thus, if the employee dies before his or her required beginning date and the 5-year rule in § 401(a)(9)(B)(iii) applied to the non-spouse designated beneficiary under the plan making the direct rollover, the 5-year rule applies for purposes of determining required minimum distributions under the IRA."

This provision appeared to mean that if the decedent died before April 1 of the calendar year following the year in which he or she attained age 70-1/2 and the distributing plan required minimum distributions to be completed within five years of the death of the participant, this rule must also apply to the recipient IRA.

The IRS has now stated that the provision quoted above should not be read this way. Instead, the IRS is now making it clear that a non-spouse beneficiary can use the life expectancy payout in the recipient IRA provided that the rollover from the distributing plan is made no later than the last day of the year following the year in which the participant died.

Background: The Internal Revenue Code provides two methods for satisfying minimum distribution rules when the participant dies prior to beginning minimum distributions: (1) pay out within five years of death (the "five-year rule"); or (2) pay out annually over the life expectancy of the beneficiary (the "life expectancy rule"). The plan sponsor can choose either approach in the plan document or leave it to the beneficiary to elect.

Under the life expectancy rule, distributions must begin to the beneficiary prior to the last day of the year following the year in which the participant dies, whereas under the five-year rule distributions can be made at any time until the last day of the fifth calendar year following the year in which the participant died. What the IRS is prohibiting, however, is a beneficiary attempting to use the five-year rule to delay distributions under the distributing plan, making a rollover within the five-year period and then using the life expectancy rule under the recipient IRA.

What all this means for non-spouse beneficiaries (and their advisors) who want to be able to stretch out distributions in a rollover IRA is that if they wait too long to make the rollover they may lose the opportunity to use the life expectancy rule in their rollover IRA.

Here is how the minimum distribution rules work in different scenarios that can occur if a participant dies before the date on which the participant is required to begin minimum distributions and the distributing plan permits non-spouse beneficiaries to make a rollover:

Scenario 1: If the rollover is completed before the end of the year in which the death occurs, the entire account balance in the distributing plan may be rolled over and the participant may use the life expectancy rule in the recipient IRA regardless of the distributing plan minimum distribution provisions.



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Scenario 2: If the rollover is completed during the calendar year following the year in which the death occurs, the minimum distribution for that calendar year may not be rolled over, but the balance may be rolled over to an IRA and the participant may apply the life expectancy rule in the recipient IRA with respect to the amount rolled over.

Scenario 3: If the rollover is completed after the end of the calendar year following the year in which the death occurred, but prior to end of the fifth calendar year following the year in which the death occurred, a rollover could still occur but the participant would be required to make minimum distributions from the recipient IRA under the five-year rule and all amounts would have to be distributed from the IRA by the end of that fifth calendar year.

Scenario 4: If a rollover is not completed by the end of the fourth calendar year following the year in which the death occurred, no rollover will be possible.

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