# Required Retirement Distril

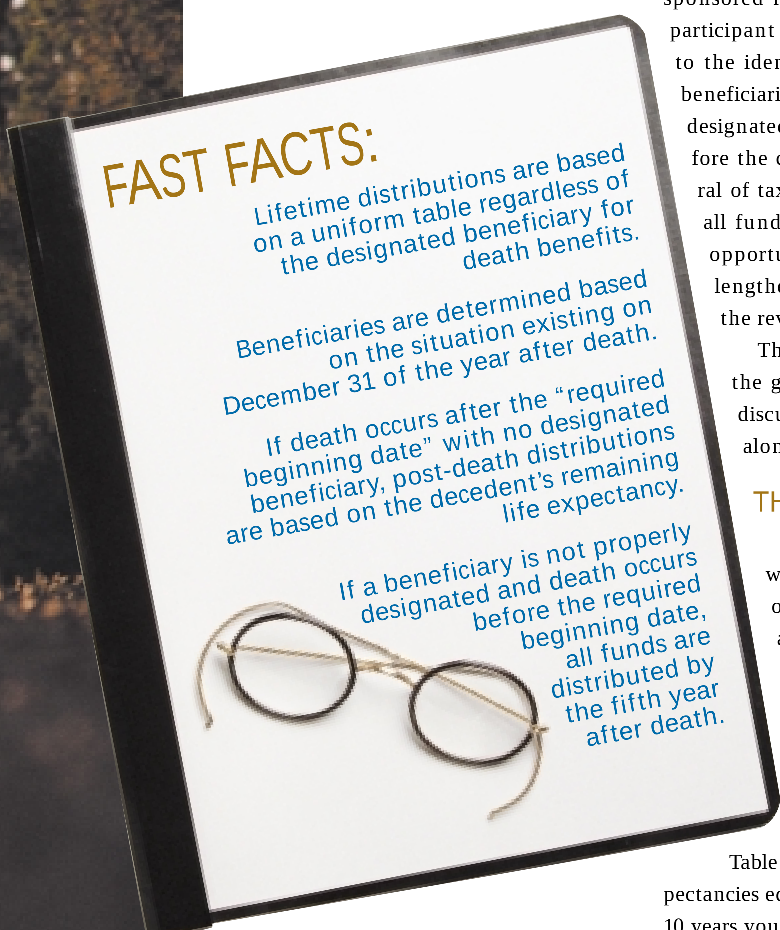
The IRS surprised everyone
by making sweeping changes
to the retirement plan
age 70½ required
distribution rules.

# ibutions Made Simple©

By *Warren J. Widmayer*

For over 13 years, practitioners have struggled through a labyrinth of decision points faced by individuals who have reached their "required beginning date," the date the tax laws require retirement fund participants to begin withdrawing their money from individual retirement accounts (IRAs), tax-deferred accounts under code section 403(b), and other employer-sponsored qualified retirement plans. Failure to properly navigate these rules resulted in a 50 percent excise tax on the erroneously undistributed portion. A number of irrevocable decisions had to be cast in stone at that date, including choice of beneficiary, whether to base distributions on joint or single life expectancies, and whether to annually recalculate life expectancies. The rules filled 60 pages of proposed regulations originally issued in 1987.

In a bold and refreshing move, in January 2001 the Internal Revenue Service proposed greatly simplified rules under IRC 401(a)(9) for determining the timing and amount of minimum required distributions from IRAs and employer-sponsored retirement plans. With one exception, distributions made while the participant is alive will now be based on one life expectancy table without regard to the identity or age of the beneficiary, leaving the participant free to change beneficiaries up to the date of death (subject to ERISA spousal rights). The table designated for this purpose is the most liberal of all the variations available before the change, allowing everyone the same opportunity for maximum deferral of taxation. A harsh rule that sometimes required complete distribution of all funds by the end of the year following death has been eliminated. New opportunities have been provided for post-mortem actions that might further lengthen the deferral period. Although the potential for excise tax remains, the revised system makes it much less likely to be assessed.




This article provides a general overview of the proposed regulations. After the general rules for lifetime distributions and distributions after death are discussed, the special options available to surviving spouses are explored, along with the new timing rules for determining the beneficiary.

## THE SIMPLE LIFETIME DISTRIBUTION

The most significant change from the old rules is the adoption of what was formerly referred to as the "MDIB table" as the universal table of divisors for determining required minimum distributions for a living account owner who has reached the required beginning date. This table is now in Prop. Reg. Section 1.401(a)(9)-5, A-4 (the Uniform Table). The Uniform Table applies only while the account owner is alive. After death, Table V of Reg. Section 1.72-9 is used.

With one exception, the minimum distribution for a distribution year is calculated by dividing the account balance on the account valuation date by the number of years (divisor) shown in the Uniform Table for the account owner's age in the distribution year. The table lists life expectancies equivalent to the joint life expectancies of the account owner and a person 10 years younger than the account owner. It also recalculates the life expectancy each year, reflecting the actuarial principle that each year a person survives, their statistical life expectancy decreases less than a year. Using this larger number as the divisor for determining the required distribution means that smaller withdrawals are required for each year, so more money can stay inside the tax-deferred account longer.

Because the lifetime distribution is standardized for almost everyone, the IRS will soon require IRA trustees to report to the account owner *and* the IRS the amount of the distribution required by the Uniform Table for each account. IRA and 403(b) account distributions for all accounts owned by an individual can still be taken from one account. Presumably, the IRS will calculate the total that should be distributed based on the new reporting and attempt to match that with 1040 and 1099-R information.

The one exception to use of the Uniform Table is the ability to use a longer distribution period for married couples when a spouse more than 10 years younger than the account owner is the sole designated beneficiary of the account.[1] As under the prior rules, IRS Table VI under Treas. Reg. Section 1.72-9 is used to determine the joint life expectancy in this case. The table is consulted each year the calculation is done, providing the benefits of lower minimum distributions as a result of recalculated life expectancies. (The old rule that required distribution of the entire remaining balance after death when both life expectancies were recalculated no longer applies. Instead, the spouse's recalculated life expectancy applies after the death of the account owner, as discussed below.) This rule is available for any year in which the younger spouse is the sole beneficiary for the entire year, so a newlywed account owner can switch to this method in the year after marriage. If the spouse ceases to be the sole beneficiary any time during a distribution year, the calculation reverts back to the Uniform Table for that year. For example, if the more-than-10-years-younger spouse dies before the account owner, the account owner reverts to the Uniform Table.[2]

The degree of simplification for lifetime distributions cannot be overstated. Except for the younger spouse situation, elections and beneficiary designations are totally ignored for lifetime minimum distribution purposes. They are still important after death, however, and the lack of a complicated decision at age 70½ may have the unintended result of procrastination or neglect of beneficiary designation decisions. Estate planners in particular should be alert to the need for proper planning for any account owner approaching this point.

# BASIC TERMS

These basic concepts are central to understanding the rules:

**Age 70½:** The date six calendar months after the 70th birthday.[1]

**Required Beginning Date:** For an IRA owner or an owner of more than five percent of a business,[2] April 1 of the year after the year age 70½ is reached. For an employee in an employment-related retirement plan who is not a five percent owner, April 1 of the year after the later of the year age 70½ is reached or the year the employee retires from the business through which contributions are made. A plan can be written to ignore the retirement rule and make age 70½ the trigger for all employees.[3]

**Designated Beneficiary:** An individual designated as a beneficiary under the plan, either by specific affirmative designation or under a plan default provision, and who is identifiable and has not received complete distribution by December 31 of the year after the account owner's death. An entity other than an individual, such as a charity, a trust, or the decedent's estate, cannot be a designated beneficiary, but the beneficiaries of a trust can be treated as designated beneficiaries if certain requirements are met.[4]

**Plan:** Individual retirement accounts (IRAs), IRC Section 403(a) annuity contracts, IRC Section 403(b) annuity or custodial accounts, stock bonus, pension, and profit sharing retirement plans qualified under IRC Section 401(a), and Section 457 government and exempt organization deferred compensation plans are subject to these rules.[5] All are referred to in this article as "plans."

**Account:** Although the rules apply to certain annuity contracts and distributions from retirement plans in the form of an annuity, most of the focus of this article is on the distribution of an IRA account, 403(b) custodial account, employer-sponsored defined contribution plan account (401(k) plan, profit sharing plan, money purchase pension plan, stock bonus plan, or ESOP), or defined benefit pension plan accrued benefit distributed in a form other than an annuity. In reality an extremely small percentage of retirees elect annuity distributions. All such benefits are called "accounts" in this article.

**Account owner:** The IRA owner, annuity owner, or participant in an employer-sponsored plan.

**Distribution year:** The calendar for which distribution is being made. The first distribution year is the year containing the event that triggers the required beginning date (the year age 70½ is attained or retirement occurs).[6]

**Account valuation date:** For an IRA or 403(b) account, the December 31 before the distribution year.[7] For any other plan, the last valuation date in the calendar year before the distribution year.[8]

### Footnotes

1. Proposed Treasury Regulation (Prop. Reg.) § 1.401(a)(9)-2, A-3.
2. IRC § 416(i); Treas. Reg. § 1.416-1, T-17.
3. Prop. Reg. § 1.401(a)(9)-2, A-2 and A-2(e).
4. Prop. Reg. § 1.401(a)(9)-1, A-1, A-3, A-5, and A-6.
5. Prop. Reg. § 1.401 (a)(9)-1, A-1.
6. Prop. Reg. § 1.401(a)(9)-5, A-1.
7. Prop. Reg. § 1.408-8, A-6; Prop. Reg. § 1.403(b)-2, A-1.
8. Prop. Reg. § 1.401(a)(9)-5, A-3.

**avoid**

## REQUIRED DISTRIBUTIONS AFTER DEATH: NON-SPOUSES

Required distributions after death have also been simplified, but not always in favor of longer deferral. Setting aside the surviving spouse situation for a moment, the general rules can be summarized fairly simply, depending on whether death occurs before or after the lifetime minimum required distributions have begun.

If death occurs after the required beginning date, the Table V[3] remaining life expectancy will be used. If there is a designated beneficiary, the beneficiary's life expectancy in the year following the year of death is used, reduced by one each year. This pattern continues after the beneficiary's death to any contingent beneficiary, based on the primary beneficiary's annually reduced remaining life expectancy.[4] If there is no designated beneficiary, the remaining life expectancy of the decedent as of the year of death is used, reduced by one each year.

The required use of the Table V single life expectancy is the only case where the deferral period has been shortened for many beneficiaries. Under the old rules, when life expectancy was not being recalculated, the joint life expectancy continued to be used after the account owner's death, reduced by one for each year since the required beginning date.[5] Under the new rules, the joint life expectancy is replaced by the single life expectancy of the beneficiary after death. This will be most significant when a significantly older surviving beneficiary's single life expectancy is much shorter than the joint life expectancy with a much younger deceased account owner. For example, an 85-year-old survivor of a 71-year-old account owner using the joint/no recalculation method under the old rules will have their divisor drop from 16 to 6.9 and will have to take more than double the distribution required under the old rules.

If death occurs before the required beginning date, the distribution period depends on whether there is a designated beneficiary.[6] If there is a designated beneficiary, the beneficiary's life expectancy based on the age at the end of the year following the year of death is used, reduced by one each year.[7] If there is no designated beneficiary or an entity other than a qualifying trust is a beneficiary, then the ''five-year rule'' applies. Under this rule, the entire account must be distributed by the end of the calendar year containing the fifth anniversary of the account owner's death.[8] The five-year rule applies in this situation even if distributions have started before the required beginning date. This is the case even if the account owner took the first distribution year's minimum distribution before the April 1 required beginning date.[9]

## SPECIAL RULES FOR SPOUSES

If the surviving spouse is the sole designated beneficiary, special rules apply. The regulations recognize that a surviving spouse is likely to be depending on the retirement funds for support, and allow spouses more flexibility than other beneficiaries, presumably to help ensure that the funds will be available when needed. The special rules include the right to delay distributions until the deceased account owner's age 70½ year; the annual recalculation of the spouse's remaining life expectancy during the spouse's life; and the right to treat the account as the spouse's own account for minimum distribution purposes. A former spouse who is an alternate payee under a qualified domestic relations order is treated as a surviving spouse for minimum distribution purposes with respect to the portion of the account assigned to the former spouse, regardless of whether the order treats the ex-spouse as the employee's spouse.[10]

The spouse is the sole beneficiary for this purpose if no other person can receive any part of the spouse's minimum required distributions payable while the spouse is alive. The Proposed Regulations state that the spouse is not the sole beneficiary when a spouse trust beneficiary could allow part of the minimum distributions to accumulate in the trust and eventually pass to remaindermen. If the trust requires all minimum required distributions to be distributed while the spouse is alive, the spouse is considered the sole beneficiary.[11]

### Spouse as Beneficiary

The account is distributed over the spouse's life expectancy similar to any other designated beneficiary, but with some modifications. Non-spouse beneficiaries have their starting life expectancy reduced by one each year, but a surviving spouse's life expectancy is recalculated each year by looking up the new divisor from Table V based on the spouse's birthday in the distribution year. This enables the spouse to stretch the account over the spouse's remaining lifetime, while a non-spouse beneficiary is required to exhaust the account over a fixed period. For example, a 70-year-old non-spouse is required to drain the account completely by age 86 (16 years), while a spouse still has a remaining life expectancy of 6.5 years at age 86 under Table V.

If the spouse dies after distributions were required to begin to the spouse, the recalculation ends at the spouse's death. Minimum required distributions from any remaining account balance at the spouse's death are based on the Table V divisor for the spouse's birthday in the year of death, reduced by one each subsequent year.[12]

The surviving spouse also can delay distribution until the end of the calendar year in

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which the account owner would have attained age 70½, if that date is later than the end of the calendar year after the account owner's death.[13] This rule applies even if the surviving spouse is well past age 70½, and this is one circumstance where not electing to treat the account as the spouse's own account may be advantageous.

If the surviving spouse dies before distributions are required to begin, the account is treated as if it were owned by the spouse, and the spouse, as account owner, died before the required beginning date (even if distributions have, in fact, begun).[14] This means that whether the five-year rule applies is based on whether the spouse has a designated beneficiary. If the spouse has a designated beneficiary, the spouse's designated beneficiary's life expectancy under Table V is used to determine minimum required distributions. When the spouse has remarried, the spouse's surviving spouse does not get the benefit of the special spouse rules.

### Election to Treat as Spouse's IRA

If the spouse is the sole beneficiary of the account and has the unlimited right to withdraw the entire account, another special opportunity is available. Instead of being treated as a beneficiary of the account owner under the special rules already described, the surviving spouse can elect to treat the account owner's IRA as his or her account for purposes of all the minimum distribution rules.[15] This is often referred to as a "spousal rollover," since it achieves the same result as if the spouse took a complete distribution and rolled over the proceeds into his or her IRA. This election may be made only after the required distribution for the year of death occurs. The election is made by either redesignating the surviving spouse as owner of the account rather than beneficiary, by failing to take a required distribution that would be required if the spouse were beneficiary rather than owner of the account, or by contributing new funds or rolling over funds from the spouse's own account to the IRA. Until the election is made in one of these ways, the IRA is treated as the deceased account owner's IRA for minimum distribution purposes and the "spouse as beneficiary" rules apply. Once the election is made, the surviving spouse is treated as the account owner for minimum distribution purposes.

The election can have unintended consequences. Once the election is made, if the spouse is less than 59½ years old and withdraws money from the account, the 10 percent excise tax under IRC 72(t) applies because the distributions are not treated as made to a beneficiary after death. The tax would not apply if the spouse did not make the election and instead took distributions as the designated beneficiary. He or she also could use the substantially equal periodic payments exception under IRC 72(t)(2)(iv), but that rule does not allow increases in withdrawal amounts unless they are built into the payment method at the start of the series.[16] For a spouse who needs the income and doesn't want to use the substantially equal payment exception, minimum (or greater) distributions can be taken as a beneficiary, based on the spouse's life expectancy until he or she is age 59½ or older, at which point he or she can become the account owner and have more flexibility until he or she reaches age 70½. Care should be taken to avoid unintentional elections in these circumstances. For example, minimum distributions based on the spouse's life expectancy should be taken each year if required, and no funds should be added to the decedent's IRA.

The new rules go further than the old rules and specifically state that the requirement that the spouse be the sole beneficiary of the IRA is not met (for spousal rollover purposes) if a trust is named as beneficiary of the IRA, even if the spouse is the sole beneficiary of the trust. It is not clear if this is intended to signal a change from prior private letter rulings that allowed rollovers into surviving spouse-owned IRAs to occur when a trust or estate was beneficiary and the surviving spouse was sole beneficiary with the right to revoke the trust, or where nobody other than the spouse had discretion to direct the funds away from the spouse.[17] These rulings centered more on whether the rollover was valid, since only the surviving spouse can roll over a death benefit distribution,[18] but sometimes cited the minimum distribution rules in the analysis. On the surface, it appears that these rulings no longer represent the official IRS position. Perhaps future guidance will clarify this issue.

The surviving spouse can also roll over a distribution from a qualified plan or 403(b) account into an IRA and treat it as his or her IRA for purposes of all the minimum distribution rules.[19]

All of these rules continue the preferential treatment of the spouse under the old rules and make it likely that the spouse will continue to be the primary beneficiary of choice for most married account owners. This is particularly true when the new flexibility in the rules for determining the designated beneficiary are considered. Dependent partners in non-marital relationships need to consider the unavailability of these advantages in their planning.

## WHO IS THE DESIGNATED BENEFICIARY, AND WHEN?

Proper designation of a beneficiary is still crucial for several reasons. A common element, regardless of when the account owner dies, is the ability to extend distribution over the beneficiary's remaining life expectancy if a proper "designated beneficiary" exists on December 31 of the year following death. If not, and death occurs before the required beginning date, then the five-year rule applies and the opportunity for extended tax deferral is lost. Finally, if the spouse is not properly designated as the sole beneficiary, all the special surviving spouse advantages are lost.

The new rules maintain the position that if non-individuals (such as estates or charities) are named as beneficiaries, the account owner has no designated beneficiary. The rules also maintain the position that if there are multiple beneficiaries of a single account, the oldest beneficiary's life expectancy will be used for all remaining minimum distributions. Beneficiaries whose rights are contingent on the death of someone else are ignored.[20]

The good news in this regard is that the new rules set December 31st of the calendar year following the calendar year of death (the beneficiary date) as the date on which the designated beneficiary is determined. The rules specifically acknowledge that payment of a beneficiary's benefit, disclaimer by a beneficiary, or other actions that eliminate beneficiary status before the beneficiary date neutralize that person or entity for purposes of determining the designated beneficiary. Emphasis is placed on the plan as the ultimate determinant of beneficiary status.[21] The regulation appears to be open-ended enough to allow court orders or contrdctual settlements that terminate beneficiary status and are recognized by the plan before the beneficiary date to have the same effect. Estates may be able to distribute to estate beneficiaries the right to receive distributions from a plan or IRA, although this will require development of new plan language recognizing such assignments as valid.

This rule provides plenty of room to avoid undesired application of the five-year rule or short life expectancies of the oldest of a group of beneficiaries. As long as the entity (probate estate or charity) or older beneficiary is out of the picture by the beneficiary date, the five-year rule will not apply and the oldest remaining beneficiary's life expectancy will be used. Likewise, if other beneficiaries can be eliminated before the beneficiary date so the surviving spouse is the sole beneficiary on that date, the special spouse rules should become available.

This also creates new administrdtive complexities for plan administrdtors who must make distributions by the same date as when the measuring life becomes fixed.

## SEPARATE ACCOUNTS

It appears that if separdte accounts can be established prior to the beneficiary date, each separdte account's minimum distribution will be based on the life expectancy of that account's beneficiary. A separdte account is defined as a portion determined by an acceptable separdte accounting including allocating investment gains and losses, contributions, and forfeitures, on a pro rdta basis in a reasonable and consistent manner (a standard similar to the Reg. Section 1.663(c) rules for separate share accounting for trusts and estates).[22]

Again, IRA and retirement plan drafters should consider adding language allowing the establishment of such separdte accounts within the year after the account owner's death when multiple beneficiaries are named.

## DESIGNATING TRUSTS AS BENEFICIARIES

Although trusts cannot be designated beneficiaries, the beneficiaries of trusts can be treated as designated beneficiaries if the trust is valid under state law, irrevocable at death of the account owner, has identifiable beneficiaries at the beneficiary date, and documentation requirements are met. Documentation requirements for post-death distributions are met if a copy of the trust or certificdtion of beneficiaries meeting the regulation's requirements are provided by the beneficiary date.[23] Documentation requirements for lifetime distributions are also listed in the regulation. These seem to apply only to the more-than-10-years-younger spouse situation, since beneficiaries are irrelevant to all other lifetime distributions.

## EFFECTIVE DATE

The rules are proposed to become effective for required minimum distributions for calendar years beginning on or after January 1, 2002. They can be relied upon until then. Qualified retirement plans must adopt a model amendment set forth in the regulation if distributions will be based on the new rules,[24] but the IRS has clarified that all recipients can rely on the new rules to determine the amount that can be treated as a "required" distribution and the amount that is eligible for rollover to an IRA.[25] IRA sponsors can follow the old or new rules and are instructed not to amend their documents.

Unless the rules are modified before they become final, beneficiaries who are currently using the joint life expectancy without recalculation method will have to start taking larger distributions beginning in 2002. For most others, the new rules appear simpler to navigate, more flexible and liberal, and are a late, but welcome sign of a more practical and sensitive regulatory approach to this area of law. ✦

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## FOOTNOTES

1. Prop. Reg. § 1.401(a)(9)-5, A-4(b).
2. Prop. Reg. § 1.401(a)(9)-5, A-4(b).
3. Treas. Reg. § 1.72-9, Table V.
4. Prop. Reg. § 1.401(a)(9)-5, A-5 and A-7(c)(2).
5. (Old) Prop. Reg. § 1.401(a)(9)-1, F-1 and F-3A(b)(1).
6. Prop. Reg. § 1.401(a)(9)-3, A-4.
7. Prop. Reg. § 1.401(a)(9)-5, A-5(c)(1).
8. Prop. Reg. § 1.401(a)(9)-3, A-4 and A-2.
9. Prop. Reg. § 1.401(a)(9)-2, A-6.
10. Prop. Reg. § 1.401(a)(9)-8, A-6.
11. Prop. Reg. § 1.401(a)(9)-5, A-7.
12. Prop. Reg. § 1.401(a)(9)-5, A-5(c)(2).
13. Prop. Reg. § 1.401(a)(9)-3, A-3(b).
14. Prop. Reg. § 1.401(a)(9)-3, A-5 and A-6.
15. Prop. Reg. § 1.408-8, A-5.
16. See IRS Notice 89-25, 1989-1 C.B. 62, and various private letter rulings approving different methodologies thereunder.
17. See, e.g., Private Letter Rulings 9811008, 9820010, and 9813018
18. IRC 408(d)(3)(C).
19. Prop. Reg. § 1.408-8, A-7.
20. Prop. Reg. § 1.401(a)(9)-4, A-3; (9)-5, A-7(a) and (c).
21. Prop. Reg. § 1.401(a)(9)-4, A-4 and A-1.
22. Prop. Reg. § 1.401(a)(9)-8, A-2 and A-3.
23. Prop. Reg. § 1.401(a)(9)-4, A-5 and A-6.
24. 66 Fed. Reg. 3934 (January 17, 2001) (notice of proposed rulemaking).
25. IRS Announcement 2001-23.