BENEFICIARY DESIGNATIONS AND IRA DISTRIBUTIONS: THE NEW RULES

By Clark M. Blackman II and Ellen J. Boling

Starting this year, minimum IRA distribution rules have been simplified, with many traps eliminated. A look at the impact of the new proposed rules on distributions after the owner's death, including designated beneficiaries and the special rights of a surviving spouse.

In January of 2001, substantial revisions were made to the "proposed" regulations concerning minimum distributions of retirement plan assets. The original proposed rules issued in 1987 were never finalized, yet they provided the only guidance available on the IRS's position regarding minimum distributions and beneficiary designations.

The new regulations will affect everyone who holds retirement assets because they impact the timing and amount of required distributions from your retirement plans, and thus, ultimately, how soon they are taxed. The good news is that the 1987 rules have been simplified.

In the April 2001 issue of the *AAII Journal*, we focused on the impact of the new proposed regulations on lifetime distributions from qualified plans (including IRAs). You can access this article on our Web site at www.aaii.com using the Search tool.

In this issue's article, we address the impact on post-death distributions, including how the designated beneficiary is identified, as well as the special rights of a surviving spouse as beneficiary.

THE DESIGNATED BENEFICIARY

When you die, minimum distributions from your retirement plan assets must be made, but the required minimum amounts vary. If there are designated beneficiaries, the required minimums are determined based on the life expectancy of the designated beneficiaries. For other beneficiaries, or if there is no beneficiary, other distribution rules apply. A "designated" beneficiary must be an individual, such as a spouse or a child, or a qualified trust; a charity, estate, or non-qualified trust does not constitute a "designated" beneficiary. The determination of designated beneficiaries for your retirement plan assets can have a big impact on how quickly the assets must be distributed, and thus, of course, how quickly they are taxed.

The recently proposed regulations provide that, generally, your designated beneficiary is determined as of the end of the year following the year of your death, rather than as of your "required beginning date" for minimum distributions or date of death (if sooner), as under the old rules.

If you have more than one designated beneficiary as of the end of the year following the year of your death, and the account has not been divided into separate accounts for each beneficiary, the beneficiary with the shortest life expectancy (in other words, the oldest beneficiary) is the "designated beneficiary" *for the purpose of determining required minimum distributions.* However, a beneficiary may be eliminated by distributing his or her share of the benefit, or through use of a "disclaimer," during the period between your death and the end of the year following the year of your death.

There are tremendous opportunities for post-mortem planning because the determination of your designated beneficiary and the corresponding calculation of life expectancy can be made as late as December 31st of the year following your death. The additional time allows for planning to determine

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the designation of a beneficiary.

"Disclaimers" may be used to affect your beneficiary; this creates planning opportunities—for instance, a spouse could disclaim to children or children could disclaim to grandchildren.

If segregation of the IRA is done by creating separate accounts for each beneficiary, each beneficiary could now use his or her own life expectancy.

The regulations also appear to allow for the payment to "non-designated" beneficiaries, such as a charity, by making the distributions prior to December 31 of the year following the year of your death.

However, it does appear that only a beneficiary who was named prior to your death can be considered for post-mortem planning. Therefore, you should designate, during your lifetime, multiple primary and/or contingent beneficiaries, so all potential individuals or trusts may be considered after your death. A beneficiary may *not* be named through language in your will. You must do this on the appropriate beneficiary form provided by the IRA custodian.

SOME EXAMPLES

Suppose you die prior to your required minimum distribution beginning date, leaving 80% of your IRA to your spouse (whose life expectancy is 12 years) and the remaining 20% to your children. If the IRA is not divided into separate accounts by the end of the year following the year of your death, the minimum distributions for the entire IRA must be made based on your spouse's 12-year life expectancy.

If, on the other hand, the IRA is divided into separate accounts by the deadline, each beneficiary will be able to use his or her own life expectancy in determining required minimum distributions.

If you leave your IRA to your

TABLE 1. 2001 PROPOSED IRA REGULATIONS: DISTRIBUTION RULES AT DEATH

Beneficiary	*Death of IRA Owner Occurs Before Required Beginning Date (RBD) for Minimum Distributions*	*Death of IRA Owner Occurs On or After Required Beginning Date (RBD) for Minimum Distributions*
Spouse	Rollover available if IRA owner's spouse is the sole beneficiary. Minimum distributions based on spouse's life expectancy.	Rollover available if IRA owner's spouse is the sole beneficiary. Minimum distributions based on spouse's life expectancy.
Non-Spouse Individual	No rollover available. Minimum distributions based on life expectancy of each beneficiary if the account is segregated. Minimum distributions based on life expectancy of the oldest beneficiary if account not segregated. If amounts received are the result of a disclaimer, the recipient may be able to use his/her life expectancy for minimum distributions.	No rollover available. Minimum distributions based on life expectancy of each beneficiary if the account is segregated. Minimum distributions based on life expectancy of the oldest beneficiary if account not segregated. If amounts received are the result of a disclaimer, the recipient may be able to use his/her life expectancy for minimum distributions.
Designated Beneficiary Trust	Minimum distributions based on life expectancy of oldest beneficiary unless a separate IRA and separate shares exist.	Minimum distributions based on life expectancy of oldest beneficiary unless a separate IRA and separate shares exist.
Estate/Non-Designated Beneficiary Trust	Minimum distributions based on five-year rule.	Minimum distributions based on IRA owner's remaining life expectancy less one each year.
Charity	Minimum distributions based on five-year rule.	Minimum distributions based on IRA owner's remaining life expectancy less one each year.
No Beneficiary	Minimum distributions based on five-year rule.	Minimum distributions based on IRA owner's remaining life expectancy less one each year.

spouse, who disclaims the account and it passes to your only child, the child could use his or her life expectancy for the minimum distribution calculation.

If the disclaimer results in the IRA passing to a "designated beneficiary trust" for the child, the trustee could use the child's life expectancy.

If the interest passes from you to a trust, of which your spouse is a beneficiary along with your child, and your spouse disclaims his/her interest in the trust, the trustee could use your child's life expectancy if the child was the only remaining beneficiary of the trust.

If you die leaving 100% of your IRA to your spouse, normally your spouse can "rollover" the IRA and treat it as his or her own. However, if your spouse disclaims 20% to your child, your spouse will no longer be the sole beneficiary, and the rollover option will not be available. As a result, your spouse would be required to take distributions over his or her remaining life expectancy beginning in the year following the year of your death. However, for the disclaimed amount, your child would be able to take distributions over his or her life expectancy because your spouse is no longer a beneficiary of that portion.

If you leave 20% of your IRA to charity (and the IRA is divided and the charity is paid off by December 31st of the year following your death), your beneficiary would be able to use his or her life expectancy for calculating distributions.

Under the old rules, if after your required minimum distribution beginning date you and your spouse elected to use the recalculation method of life expectancies, and your spouse died before you, the remaining beneficiaries would be required to distribute 100% of the account balance by December 31 of the year following the year of death. Under the 2001 proposed rules, the beneficiaries can now use their life expectancies for purposes of calculating the required distribution.

THE DEFAULT RULE

Under the old rules, if you died before your required beginning date for minimum distributions, the post-death distribution of the total account balance was required to be made within five years of your death if your estate was your beneficiary, or if your spouse or other heir neglected to begin taking distributions on a timely basis.

The new rules change the default rule for a non-spouse beneficiary if you die before your required beginning date. Therefore, absent a plan provision, the life expectancy rule would be applied in all cases in which you have a designated beneficiary. As in the case where you die on or after your required beginning date, your designated beneficiary (whose life expectancy is used to determine the distribution period) would be determined as of the end of the year following the year of your death. The five-year rule would apply automatically *only* if you did not have a designated beneficiary, or your estate or a charity is your beneficiary as of the end of the year following the year of your death.

TRUSTS AS BENEFICIARIES

The new rules retain the provision allowing a beneficiary of a trust to be your "designated" beneficiary (when the trust is named as the beneficiary of your retirement plan or IRA), provided that certain requirements are met. One of these requirements is that documentation of the beneficiaries of the trust be provided in a timely fashion to your plan administrator. In the case of individual accounts, unless the lifetime distribution period for you is measured by the joint life expectancy of you and your spouse, the deadline under the new rules for providing the beneficiary documentation would be the end of the year following the year of your death. This is consistent with the deadline for determining your designated beneficiary. Because the designated beneficiary (during your lifetime) in most cases is not relevant for determining lifetime required minimum distributions, the burden of lifetime documentation requirements contained in the old rules is significantly reduced.

In general, only an individual may be a "designated beneficiary" for purposes of determining the distribution period. However, if the following requirements are met, the beneficiaries of the trust will be treated as having been "designated beneficiaries" of your plan for determining the distribution period:

- The trust is valid under state law, or would be but for the fact that there is no corpus;
- The trust is irrevocable or will, by its terms, become irrevocable upon the death of the IRA owner;
- The beneficiaries are clearly identifiable from the trust instrument; and
- Proper "documentation" (a copy of the trust document) is provided to the "plan administrator" or IRA custodian.

SPOUSAL IRA INHERITANCES

The new rules clarify the existing rule that allows your surviving spouse to elect to treat your IRA as his or her own IRA. The old rules provided that this election is deemed to have been made if your surviving spouse contributes to the IRA or does not take the required minimum distribution as a beneficiary of the IRA. The new rules clarify that this deemed election is permitted to be made only after the distribution of the required minimum amount for the account, if any, for the year of your death.

Further, these new proposed regulations clarify that this deemed election is permitted only if your spouse is the sole beneficiary of your account and has an unlimited right to withdrawal from the account. This requirement is not satisfied if a trust is named as beneficiary of the IRA, even if your spouse is the sole

beneficiary of the trust. These clarifications make the election consistent with the underlying premise that your surviving spouse could have received a distribution of the entire IRA and rolled it over to an IRA established in his or her own name as IRA owner.

These new "proposed" regulations also clarify that, except for the required minimum distribution for the year of your death, your spouse is permitted to roll over the post-death required minimum distribution for a year if your spouse is establishing the IRA rollover account in his or her name as IRA owner.

However, if your surviving spouse is age 70½ or older, the minimum lifetime distribution required must be made for the year and, because it is a required minimum distribution, that amount may not be rolled over. The proposed regulations provide that this election by your surviving spouse eligible to treat an IRA as his or her own may also be accomplished by re-designating the IRA with the name of your surviving spouse as owner rather than beneficiary.

CONCLUSION

The 2001 proposed regulations simplify the IRA distribution rules, eliminating many traps. Although presented by the IRS as proposed regulations, they provide the only substantive direction provided by the government in this area, and they replace the old "proposed" regulations. Therefore, they should be followed as if finalized into law.

Unfortunately, these regulations do not address all the potential situations, so the need for distribution planning in both retirement and estate planning, especially for large IRAs, is still very important.

Table 1 provides a quick reference for the new required minimum distribution provisions. ❖