BENEFICIARY DESIGNATIONS AND REQUIRED MINIMUM DISTRIBUTIONS

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To properly plan for retirement distributions, you need to navigate around complex IRS rules on required minimum distributions and designated beneficiaries. Guidelines to help avoid costly mistakes.

Saving for retirement with 401(k)s, IRAs, and other tax-advantaged accounts has one drawback: Eventually, you'll have to start taking the money out of those accounts and pay the required taxes. If not done properly, taking these distributions can result in excess taxes and tax penalties—not only for you, but also for your spouse and your survivors.

The rules for distributions can be tricky. This article provides some guidelines.

KEY PLANNING CONSIDERATIONS

To plan a successful retirement distribution strategy, you must evaluate how the following key considerations affect your situation:

- Your personal goals. For instance, do you wish to maximize the aftertax proceeds to heirs or to a favored charity?
- Your health and the health of your ultimate beneficiaries.
- Current and projected income tax brackets.
- Deferral of estate taxes on IRA assets using the marital deduction.

Most people will first wish to maximize their aftertax cash flow during retirement. Second, they'll wish to maximize retirement benefits for their spouse in the event of their death. Third, they'll aim to pay the remainder to their children at the spouse's death—at the lowest possible tax cost.

In order to help you properly plan a retirement distribution strategy, you must understand several key concepts:

- The required beginning date for minimum distributions under IRS rules.
- The methods used to calculate minimum distributions.
- The rules surrounding designated beneficiaries and their life expectancies.

THE MINIMUM DISTRIBUTION RULES

Minimum distributions from IRAs and qualified plans must begin no later than the "required beginning date." That date is April 1 of the calendar year *following* the calendar year in which you (the owner) attain 70½ years of age. (There are some limited exceptions, such as Roth IRAs.)

The actual distribution may be made from one, several, or all of your various IRA and qualified plan accounts, but the total amount distributed must equal or exceed the calculated minimum required distribution for all plans combined (including tax-deferred annuities that have not yet been annuitized).

The first-year distribution, for the year in which you turn 70½, may be made as late as April 1 of the next year, but all future annual distributions must be made by Dec. 31 of each year. So, if you turn 70½ in June 1998, your 1998 distribution could be taken by Dec. 31, 1998, or deferred until no later than April 1, 1999. You would, however, have to take your 1999 distribution in 1999 as well. This could elevate you to a higher tax bracket

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in 1999, depending on the size of your required distribution.

A 50% tax penalty applies if the minimum required amount is not distributed on a timely basis. The penalty is 50% of the difference between the actual amount distributed and the amount that should have been distributed, and it is in addition to the regular tax on the distribution. The IRS can, and typically will, waive this penalty when the failure to distribute is inadvertent and steps are taken to immediately distribute the required amounts.

THE CALCULATION

The amount of the required minimum distributions depends on the account owner's age and the age of the designated beneficiary, if any, of each account. Your annual distribution for each year is the balance in your IRA or qualified retirement plan as of Dec. 31 of the prior year divided by the life expectancy factor (either single or joint) for your age in the current year. Life expectancy tables for various ages can be found in Tables V and VI of Income Tax Regulation 1.72-9, or in Appendix E of IRS Publication 590.

The concept of a "designated" beneficiary is important in calculating minimum distributions during your lifetime because distributions can be paid over the joint life expectancy of the owner and the designated beneficiary. If a designated beneficiary is named, the required distributions can be spread out over a greater number of years, since the life expectancy of two individuals is always greater than for one. However, this does have limitations: If a non-spouse beneficiary is chosen, the joint life expectancy factor is calculated as if the difference between the owner's and the beneficiary's actual ages is no more than 10 years (the 10-year age difference rule).

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.

Based on the beneficiary chosen, it is also possible that taxable distributions can be delayed further upon the death of the plan owner. If a spouse is the designated beneficiary, he or she has several options. One option unique to spouses is that he or she may choose to roll over the inherited account into his or her own IRA and then select a new designated beneficiary for purposes of calculating minimum distributions.

RECALCULATION

To further complicate matters, in determining your annual distributions you can choose to recalculate your own life expectancy, your spouse's life expectancy, or both (see below for explanation). However, the life expectancy of a non-spouse beneficiary cannot be recalculated.

With recalculation, a new life expectancy is determined each year, reflecting the fact that an individual does not lose a year of life expectancy for every year that passes. For example, if you use a fixed-life (or "term certain") approach—in other words, no recalculation—and you use a single life expectancy, each year's distribution is based on the life expectancy at the required beginning distribution date, less the number of years of distributions taken: If you are age 70½, your life expectancy is 16 years and you would divide the account balance by 16; in the next year, you must use a life expectancy of 15 years and divide the account balance by 15; in the year after that, you must use a life expectancy of 14, and so on. At age 86, the remaining IRA balance is distributed.

Conversely, under the recalculation method, at age 71 your single life expectancy is 15.3 years, and it will not run out until the table used for these calculations ends at age 110, when the factor equals one. So, you would not likely outlive the account if you only withdrew the required minimum distributions each year. *The election to use a fixed-life or to recalculate is irrevocable as of the required beginning date.*

The fixed-life, or "term certain," approach will accelerate the annual distributions and resulting tax liability. Therefore, recalculation provides an income tax benefit by allowing a longer period of tax deferral during the IRA owner's lifetime. In addition, if a "designated" beneficiary is named as of the required beginning date, the balance can be paid over the beneficiary's life expectancy after the owner's death. If no designated beneficiary is named, and the recalculation method is chosen, 100% of the plan balance must be distributed before Dec. 31 of the year following death. (Note: Prior to age 70½, IRA proceeds must be distributed by Dec. 31 of the fifth year following the death of the plan owner when no designated beneficiary has been named.)

A word of caution, however: Though it may make sense to recalculate *your* life expectancy, you may not want to recalculate your spouse's life expectancy, because it will accelerate the taxable income distributable to you following your spouse's death. This is because when the spouse dies, the recalculated life expectancy becomes zero the year following death. In addition, it can require acceleration of income tax payable by heirs at the death of both you and your spouse. Let's say, for example, you are 75 and your spouse is 67, you both die in a common accident, and at the time of death there is $1 million in your IRA. If both life expectancies were being recalculated, the entire IRA must be distributed to your heirs before Dec. 31 of the year after the year of your deaths. However, if your life expectancy is recalculated but your spouse's isn't, then your

heirs could continue to receive distributions over your spouse's remaining "life expectancy" at death, which is 16.5 years. (In other words, the spouse's life expectancy at age 62, when you were 70½, was 22.5, and there were six years of minimum required distributions: 22.5 – 6 = 16.5).

What if you decide to replace a living beneficiary after your required beginning date with a new designated beneficiary? You can do this, but your payout will continue to be based on the life expectancy using the original beneficiary. The only exception to this rule is if you replace the original beneficiary with an older beneficiary, or a "non-designated" beneficiary (for instance, an estate or charity). The shorter life expectancy must then be used, which will accelerate the minimum distributions required. You must "look back" to your required beginning date and use the life expectancy of the replacement beneficiary at that time, reduced by one for each year a distribution was taken. If a new "designated"

TABLE 1. WHICH DISTRIBUTION OPTION SHOULD YOU USE? SOME TYPICAL SITUATIONS

Need & Situation	Suggested Action	Result
• Maximize retirement income • Owner is married	*Beneficiary*: Designate spouse as beneficiary. *Distribution Option:* Recalculate both life expectancies.	You will not "outlive" the account because distributions are based on a life expectancy factor that decreases by less than one year for each year that elapses; during your lifetime the account is not fully distributed until the younger of you reach age 110.
• Maximize retirement income • Owner is single	*Beneficiary:* Designate a beneficiary from a younger generation (but beware of generation-skipping tax). *Distribution Option*: Recalculate your life expectancy only.	You will not "outlive" the account because distributions are based on a life expectancy factor that decreases by less than one year for each year that elapses and is further reduced by the life expectancy of the beneficiary (subject to the 10-year rule); the account is not fully distributed until the later of your age 110 or the end of the term established by the age of the beneficiary.
• Maximize wealth transfers • Owner is married	*Beneficiary:* Designate spouse as beneficiary. *Distribution Option*: Recalculate your life expectancy only. *Upon Your Death*: Surviving spouse rolls over account to his/her own IRA, designates child/grandchild as beneficiary, and elects recalculation option.	Minimizes distributions during your lifetime, and continues deferral of payouts during surviving spouse's lifetime based on joint life expectancy of spouse and beneficiary (subject to the 10-year age difference rule). Distributions after surviving spouse's death are based on the table life expectancy of beneficiary only, without regard to 10-year age difference rule.
• Maximize wealth transfers • Owner is single	*Beneficiary*: Designate a beneficiary from a younger generation (but beware of generation-skipping tax). *Distribution Option*: Recalculate your life expectancy only.	Extends distributions over the joint life expectancy of you and beneficiary (note: 10-year age difference limit). Distributions after your death are based on the table life expectancy of beneficiary only, without regard to 10-year age difference rule.

beneficiary is not named, the payout must be based on your single life expectancy. The rules are different if your first beneficiary dies after your required beginning date. In this case, replacing the deceased with an older designated beneficiary, or a non-designated beneficiary (such as an estate, charity or non-qualified trust) will not require a change in distributions unless you had elected to recalculate the original beneficiary's life expectancy.

KNOW THE PLAN TERMS

It is important to understand that the terms of the IRA or qualified retirement plan may limit distribution options. For example, some IRA agreements don't permit recalculation of life expectancies, and some provide only lump-sum distributions after death. Many will not allow a combination of the fixed-life and recalculation options.

The tax law is much more flexible than many IRA agreements. Read the IRA agreement carefully and make sure you understand your options. Make an informed decision about naming beneficiaries and taking future minimum distributions based on your personal needs.

WHICH SHOULD YOU USE?

Several typical retirement planning situations involving qualified retirement plan distributions are outlined in Table 1, along with suggested actions to consider. The key factor in all situations is to understand the role you need the retirement plan to fulfill in providing for future income needs—will distributions be needed to fund current living expenses, or do you want to defer and minimize distributions as long as possible to maximize the aftertax wealth you will pass on to heirs?

Of course, your health and your spouse's health are key factors in the decision process, and the examples below assume both of you are very healthy. The examples also assume that the retirement plans allow all possible distribution options.

- *Need: Maximize retirement income*

—Retirement plan owner is married

Designate your spouse as the beneficiary and recalculate both of your life expectancies. Neither of you will "outlive" the account using this approach because distributions are based on a life expectancy factor that decreases less than one year for each year that elapses. Under this scenario, the account will not be fully distributed until the younger of the two of you reach age 110.

—Retirement plan owner is single

Designate a retirement plan beneficiary from a younger generation (but beware of the generation-skipping tax), and recalculate your life expectancy only (you may not recalculate the non-spouse's life expectancy). You will not outlive the account using this approach because distributions are based on a life expectancy factor that decreases less than one year for each year that elapses and is further reduced by the life expectancy of the younger beneficiary (subject to the 10-year rule). Under this scenario, the account is not fully distributed until the later of your age 110 or the end of the term established by the age of the younger beneficiary.

- *Need: Maximize wealth transfers*

—Retirement plan owner is married

Designate your spouse as the retirement plan beneficiary and recalculate only your life expectancy. Upon your death, your spouse can roll the retirement plan account over to his or her own IRA, designate a child or grandchild as a beneficiary, and choose the recalculation option. This approach minimizes distributions during your lifetime, and continues the deferral of payouts during the surviving spouse's lifetime based on your spouse's joint life expectancy with the younger beneficiary (subject to the 10-year age difference rule). Distributions after the surviving spouse's death are based on the younger beneficiary's life expectancy only, without regard to the 10-year age difference rule.

—Retirement plan owner is single

Designate a beneficiary from a younger generation (but beware of the generation-skipping tax) and recalculate your life expectancy. This approach extends the distributions from the account over the joint life expectancy of you and your beneficiary (subject to the 10-year age difference rule), and distributions after your death are based on the life expectancy of your beneficiary only, without regard to the 10-year age difference rule.

CONCLUSION

As you can see, this issue is complex and full of pitfalls. The best strategy for each individual may be different depending on personal income needs, marital status, health, potential beneficiaries and other assets available to fund long-term living expenses. This is a dangerous area for "do-it-yourselfers," and you may want to seek the advice of a professional adviser knowledgeable about these issues.

In the next article, we will discuss in greater detail the impact of the minimum distribution rules on your estate. ◆