



RETIREMENT PLANS

Among the most complex and confusing rules are those concerning distributions and beneficiaries—and they involve irrevocable elections at age 70½.

The Rules for Required Minimum Distributions & Beneficiary Designations

By Clark M. Blackman II and Kevin P. McAuliffe

Over the past year, we have addressed many of the more important rules relating to the taxation of IRAs and qualified retirement plan assets, such as 401(k), profit-sharing, and Keogh plans. These rules can be complex and confusing, and none are more difficult to understand than those dealing with IRA beneficiary designations and their impact on your retirement and estate planning.

We will address this area in the next two articles. This month's article will lay out some of the basic rules you should know in planning for IRA and qualified retirement plan distributions during life and after death. Our next article will focus on some of the many planning opportunities to consider in applying the rules.

The Basic Rules for Distribution

To simplify presentation of these complex rules, we will designate Sam as the IRA owner (or qualified plan participant)

throughout the article; his spouse will be referred to as Louise.

In order to properly plan his retirement distribution strategy, Sam must understand several key concepts:

- The required beginning date for minimum distributions under IRS rules,
- The methods that can be used to calculate minimum distributions,
- The rules surrounding designated beneficiaries and their life expectancies, and
- The effect, if any, of penalty taxes (primarily the 10% early distributions and 15% excess distributions/accumulations penalties discussed in prior *AAII Journal* articles).

The Minimum Distribution Rules

Minimum distributions from IRAs and qualified plans must begin no later than the "required beginning date," which is (with some limited exceptions) April 1 of the calendar year following the calendar

year in which Sam attains age 70½. The actual distribution may be made from one, several, or all of Sam's 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 all tax-deferred annuities that have not yet been annuitized).

The first-year distribution, for the year Sam turns 70½, may be made as late as April 1 of the next year, but all future annual distributions must be made by December 31 of each year. So, if Sam turned 70½ in June of 1996, his 1996 distribution could be taken by December 31, 1996, or deferred until April of 1997. However, he would still have to take his 1997 distribution by December 31, 1997, resulting in two 1997 distributions. This could create a 15% excess distribution tax problem in 1997, depending on the size of Sam's required distributions.

A 50% 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 waive this penalty when the failure to distribute is inadvertent and steps are taken to immediately distribute required amounts.

Calculating Minimum Distributions

The amount of the required minimum distribution depends on Sam's age and the age of the designated beneficiary, if any, of each of his accounts. Life expectancy tables for various ages can be found in Table V of Income Tax Regulation 1.72-9, or in Appendix E of IRS Publication 590, available from local IRS offices. Sam's annual distribution for each year is his IRA or qualified plan balance at December 31 of the prior year, divided by the life expectancy factor (either single or joint) for his current age.

The concept of a designated beneficiary is important in calculating minimum distributions during life because distributions can be paid over the single life expectancy of the plan participant or

Clark M. Blackman II, CPA/PFS, CFA is Price Waterhouse's director of Personal Financial Services in Houston (713/654-4100). Kevin P. McAuliffe, JD, CPA/PFS, LLM (Taxation) is a senior manager in the Personal Financial Services unit in Price Waterhouse's Chicago office (312/540-1500).

the joint life expectancy of the participant and a 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. Also, as explained later, at death it is possible to further delay taxable distributions based on the beneficiary chosen. A designated beneficiary must be an individual (such as a spouse or children), or a qualified trust. A charity, estate or non-qualified trust does not constitute a designated beneficiary.

To further complicate matters, Sam can choose to *recalculate* his life expectancy, his spouse's life expectancy, or both. (However, the life expectancy of a non-spouse beneficiary cannot be recalculated.) Under this method, a new life expectancy is determined each year, reflecting the fact that we don't lose a year of life expectancy for every year that we age.

For example, if Sam uses a fixed life approach and his single life expectancy, each year's distribution is based on his life expectancy at the beginning distribution date, less the number of years of distributions taken. Thus, if 16 is his life expectancy at age 70½, then the following year 15 must be used, then 14, 13 and so on until at age 86 the entire IRA balance is distributed. Conversely, under the recalculation method, at age 71 Bill's life expectancy is 15.3 years, and it will not run out until the table used for these calculations ends—at age 115. *Remember that the election to use fixed-life or recalculate is irrevocable as of the required beginning date.*

The fixed-life approach will accelerate the annual distributions and the resulting tax liability. Recalculation will provide an income tax benefit by allowing a longer period of tax deferral during the IRA owner's lifetime. In addition, if a 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. Otherwise, 100% of the plan balance must be distributed before December 31 of the year following death. (Note: As explained below, *prior to age 70½*, IRA proceeds must be distributed by December 31 of the fifth year

following death of the plan owner when no designated beneficiary has been named.)

A word of caution, however: Even though it may make sense to recalculate your life expectancy, you generally should not recalculate your spouse's life expectancy, as it will accelerate the income tax payable by your heirs at the death of you and your spouse. Let's say, for example, Sam is age 75 and Louise is 67, and both die in a common accident with \$1,000,000 in Sam's IRA. If both life expectancies were being recalculated, the entire IRA balance would have to be distributed to their heirs before December 31 of the year after their deaths. However, if Sam's life expectancy is recalculated but Louise's isn't, then their heirs could continue to receive distributions over her remaining life expectancy at death, which is 22 years (that's right, under tax law a spouse would have a remaining life expectancy even though he or she died.)

Distributions After Death

All of the above concepts are critical in determining whether distributions and income taxes can be deferred beyond Sam's death, and if so, for how long. With this in mind, we'll contrast what happens when Sam dies before and after the required beginning date described above.

Death before the required beginning date:

If Sam dies before the required beginning date, in general, all IRA and qualified plan proceeds would be distributed under the following rules:

1.) If Sam did not name a designated beneficiary, the entire account must be distributed to his heirs by December 31 of the fifth year following the year of his death (the so-called Five-Year Rule).

2.) If Sam named a designated beneficiary, the rules are different.

If Louise was the designated beneficiary, she has the following options:

- Take distributions over her life expectancy, beginning prior to December 31 of the year following Sam's death.
- Delay distributions until no later than December 31 of the year Sam would have turned age 70½. Distributions

are then calculated based on Louise's life expectancy.

- Take Sam's IRA and/or qualified plan proceeds and roll them over into a new IRA with new beneficiary designations. Louise could then wait until her age 70½ to begin taking distributions.

- Elect to have the five-year rule apply, and withdraw the funds by December 31 of the fifth year following the year of his death.

If Sam designated a beneficiary other than Louise (such as a child), then the options are:

- Distribute the remaining balance over the beneficiary's life expectancy, but distributions must begin before December 31 of the year following Sam's death.

- Elect to have the five-year rule apply, and withdraw the funds by December 31 of the fifth year following the year of his death.

Death after the required beginning date:

If Sam dies after minimum distributions have begun, the tax consequences depend on who was his designated beneficiary and whether he recalculated his life expectancy. Let's look at three different beneficiary options: (1) a spouse beneficiary, (2) a non-spouse beneficiary, such as a child or grandchild, and (3) a qualified trust[s] beneficiary.

(1) The spouse as designated beneficiary: If Louise is the designated beneficiary, she can elect from the following options at Sam's death.

- She can continue to take minimum distributions at least as rapidly as under the method chosen by Sam. If Sam had recalculated his life expectancy, then Louise's remaining life expectancy alone (either recalculated or fixed) would be used to determine her payments. If Sam did *not* recalculate his life expectancy, Louise could continue to take distributions based on his and her combined life expectancy even though Sam is dead. As explained earlier, if Louise's life expectancy is being recalculated, then at her death, the entire plan must be distributed prior

to December 31 of the year following date of death. If Louise's life expectancy is not being recalculated, then her beneficiaries could continue to receive distributions until the year determined to be her life expectancy, as of the date she died.

- She can take Sam's IRA and/or qualified plan proceeds and roll the distribution over to a new IRA. As owner of the IRA, Louise can name her own designated beneficiaries and take applicable minimum distributions based on her own life expectancy and, if desired, that of a designated beneficiary. Upon Louise's death, distributions could continue to beneficiaries based on their life expectancies.

(2) Non-spouse beneficiaries: Non-spouse designated beneficiaries, such as children or grandchildren, may begin taking distributions the year following the date of death. The life expectancy of a non-spouse beneficiary cannot be recalculated, and it is based on the number of years of life expectancy as of the year Sam turned 70½. For example, if the beneficiary is age 16 when Sam turned 70½ and the life expectancy at age 16 is age 65.8 (49.8 more years), then if Sam dies at age 75, distributions would begin the following year at a rate of 1/43.8 (49.8 minus 6 years). The following year distribution rate would be 1/42.8, and so on.

Keep in mind, however, that while post-death distributions can be paid to beneficiaries based on their life expectancies, Sam can't reduce minimum distributions during his lifetime by naming a very young grandchild, for example, as his beneficiary for determining joint life expectancy. A special rule requires that a non-spouse beneficiary cannot be treated as being more than 10 years younger than the owner for purposes of the owner's minimum required distributions.

In addition to this rule, if there are multiple non-spouse beneficiaries (three children, for example), you must use the life expectancy of the oldest beneficiary in calculating distributions during lifetime. For example, assume that at age 70½, Louise named three grandchildren,

ages 8, 10 and 12, as beneficiaries of her IRAs. During Louise's lifetime, minimum IRA distributions are based on her life expectancy and the life expectancy of the oldest non-spouse beneficiary, but not exceeding 10 years. If Louise dies at age 80, the remaining IRA proceeds can be distributed over the next 47.7 years to the three grandchildren. This is calculated by taking the oldest child's life expectancy at Louise's age 70½, less the 10 years which have elapsed: at age 12, life expectancy is 69.7 years of age, or 57.7 more years (69.7 less 12); since 10 years have elapsed since distributions began, this figure is reduced to 47.7 (57.7 less 10); thus, the proceeds are divided by 47.7 the first year; 46.7 the second year, etc.

Warning: in this case, Louise skipped a generation of estate tax payers (her children). The IRS will tax amounts in excess of \$1,000,000, which skip a generation, at a rate of 55%. This generation-skipping tax must be considered when making grandchildren the beneficiaries of IRAs.

(3) Qualified trusts as beneficiaries:

Trusts created to provide estate tax benefits, such as unified credit trusts and QTIP trusts, can be named as beneficiaries of IRA plans. [For more on this topic, see "Should a Trust Be Beneficiary of Your IRA?," by Clark Blackman in the October 1991 *AAIL Journal*]. Generally, as mentioned above, trusts are not considered designated beneficiaries and, therefore, plan proceeds would need to be distributed within five years of the date of death. However, if certain rules are met, the beneficiaries of the trusts can be treated as the designated beneficiaries of the IRA or qualified plan. In general, the trust must be valid under state law and meet the following tests:

- It must be irrevocable as of the required beginning date (otherwise you will not have a designated beneficiary),
- The beneficiaries must be identifiable from the trust instrument, and
- A copy of the trust instrument must be provided to the qualified plan or IRA custodian.

If Sam names a qualified trust as ben-

eficiary, the above rules for designated beneficiaries apply. However, Louise cannot roll the IRA proceeds over to her own account. Remember that the age of Sam's oldest trust beneficiary will determine the minimum size of his lifetime distributions.

There are many issues to be considered when using qualified trusts and we can only touch on several in this article. The most important considerations are:

1.) Using the unified credit trust as beneficiary means that Sam's heirs may not receive the full benefit of the \$600,000 estate tax exemption. The reason is that all IRA dollars distributed are fully taxable as ordinary income. Therefore, his beneficiaries only get the remainder of the proceeds after income taxes are paid. Sam should only use the credit trust for his IRAs if no other assets are available for funding.

2.) By designating the QTIP trust as beneficiary, Sam may create income tax consequences that are not as favorable as if Louise were named as beneficiary directly. First, generally no rollover is allowed, so Louise is limited as to distribution options and at her death, the five-year rule will typically apply. Second, all income from the QTIP trust must be distributed each year, including income from the IRA. Therefore, distributions in excess of the required minimum distribution amount may be necessary, thereby accelerating the income tax consequences and possibly triggering the 15% excess distributions tax. It is also essential that the trust and plan documents require all income be distributed annually.

If Beneficiary Dies First

After the required beginning date, Sam cannot change his calculation options. But, if his beneficiary dies, Sam has several options depending on his relationship to the beneficiary (spouse or non-spouse) and their respective ages.

If Louise was Sam's beneficiary, and he elected to recalculate her life expectancy, then his remaining distributions will be based on his single life expectancy, since Louise's life expectancy is reduced to zero. Otherwise, Sam's distri-

butions will continue in the manner he established before Louise died.

If, however, Sam named a contingent beneficiary as of the required beginning date who would be entitled to the account if Louise died, then his options depend on whether the contingent beneficiary had a shorter or longer life expectancy than Louise. If the new beneficiary, a child for example, has a longer life expectancy, then Sam would continue to use Louise's life expectancy along with his own. If the contingent beneficiary has a shorter life expectancy, such as an older sister, Sam can use the new beneficiary's life expectancy in determining his distributions, but must "look back," i.e., as-

sume that his sister was his designated beneficiary as of his required beginning date. If he doesn't elect this option, he would use his single life expectancy as if no contingent beneficiary were named.

Finally, if a child or other non-spouse beneficiary died, in general Sam simply continues to use the same distribution pattern he established. Even if Sam names a new beneficiary, as long as he is receiving minimum distributions, the new beneficiary is ignored.

Know the Terms of Your Plan

It is important to understand that the terms of your IRA or qualified plan may

limit your distribution options. For example, some IRA agreements don't permit recalculation of life expectancies, and some provide only for lump-sum distributions after death. The tax law is much more flexible than many IRA agreements, so shop around and read the IRA agreement carefully before you invest your funds.

The foregoing presented the basic rules for determining life expectancy and minimum distributions. In the next column, we will discuss how to evaluate which options make sense in given situations, and evaluate several others, such as naming a charity or charitable trust as beneficiary.



New Mutual Fund Book Sets You on the Right Investment Path!

**"Building Your Mutual Fund Portfolio"
by Albert J. Fredman and Russ Wiles
Published by Dearborn Financial Publishing**

Interest Rate Uncertainty. . . Risky Derivatives. . . Mexican Peso Crisis . . . Money Market Fund Below \$1 per Share

Financial stories such as these have increased investor fear and confusion of late. The antidote? A clear understanding of investment risk and how you can balance it against return in a portfolio of mutual funds that meets your goals. Albert Fredman, AAIL's mutual funds columnist, and Russ Wiles impart this crucial knowledge in their new book "Building Your Mutual Fund Portfolio: A Passport to Low-Risk, High-Return Investing."

Taking you on a journey through the mutual fund landscape, the authors focus on using asset allocation to achieve the optimal portfolio mix between stocks, bonds, and cash for your chosen investment path. The various avenues explored include growth investing, income investing, small-stock funds, international funds, and index funds. The hazards investors face—inflation, taxes, high investment costs, and misleading advice—are explained with strategies for avoiding common mistakes. The authors also teach you how to weather bear markets by understanding the pitfalls of market timing and taking advantage of bargain hunting. The book includes sample portfolios, brief profiles of several portfolio managers, and investment opportunities in the next decade. A list of 101 investment tips gives you a comprehensive and concise checklist to direct your journey in the most profitable and cost-effective way.

AAIL is pleased to offer this book to our members at a 20% discount from the retail price. AAIL member price: \$15.95. To order, call AAIL at (800) 428-2244 or (312) 280-0170 or send in the postpaid envelope in this issue. Orders can also be taken by fax at (312) 280-9883 or E-mail at AAILMembr@aol.com. Please specify the book title when ordering.