PART 3: MINIMUM DISTRIBUTIONS AND BENEFICIARY DESIGNATIONS

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Minimizing distributions from retirement plans during your own life as well as for heirs involves many complex and confusing rules; considerable confusion seems to focus on the decision of whether and when to elect to recalculate life expectancy. This article is designed to guide you through the maze of choices.

The planning area of beneficiary designations and minimum distributions is exceedingly complex. For every rule there are a myriad of caveats that take you through a maze of questions leading to alternatives that must be considered. In response to our first two articles, we received numerous follow-up questions. Many of them focused on the decision of whether and when to elect to recalculate life expectancy for determining the required minimum distribution. In this article, we address those questions to help provide you with further clarification and guidance through the maze.

WHAT ARE THE CHOICES?

Question #1: What are the choices for calculating life expectancy to determine minimum distributions—can the account owner choose one method and the beneficiary another?

If you are the owner of a qualified retirement plan (this includes 401(k)s, Keoghs, defined benefit and defined contribution plans as well as individual retirement accounts, although for simplicity sake, we will in this article refer to IRAs), you are required to start taking distributions from the plan once you have reached the required beginning date, which is April 1 of the calendar year following the calendar year in which you reach 70½.

Your required minimum distribution is determined by taking the retirement plan's balance as of December 31 of the prior year, and dividing it by the life expectancy factor, either single or joint, for your current age.

If you have chosen to distribute based on a single life expectancy, you may, as the owner of the plan, choose to recalculate your life expectancy factor each year. Alternately, you may choose not to recalculate. If you choose not to recalculate, you would simply determine your life expectancy factor when you are age 70½, and then reduce that factor by one for each year that elapses.

If you choose to recalculate each year, you determine your life expectancy factor each year based on your current age. Why would you want to recalculate? In the life expectancy tables, an individual does not lose a year of life expectancy for each year that passes, so your life expectancy factor goes down more slowly than if you do not recalculate, and required minimum distributions are therefore smaller.

What about recalculating if you have chosen to distribute based on a joint life expectancy?

If you, as the owner, name a designated beneficiary and elect to calculate a joint life expectancy factor for determining minimum distributions, you retain the ability to choose whether or not to recalculate your life expectancy. Whether the designated beneficiary's life expectancy can be recalculated or not depends on who the designated beneficiary is. If the designated beneficiary is your spouse, your spouse's life expectancy may be recalculated each year. If the designated beneficiary is not your spouse, the designated

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beneficiary's life expectancy may not be recalculated. The choices are listed in Table 1.

WHERE ARE THE FACTORS?

Question #2: Where do I find life expectancy factors, particularly if I choose to recalculate my life expectancy but not the life expectancy of my spouse, who is the designated beneficiary? The tables don't seem to apply to this situation.

Life expectancy tables for various ages can be found in Internal Revenue Code Regulations (IRC Regs) 1.72-9, Tables V (for single life expectancy) and Table VI (for joint life expectancy). Also, these tables are available in Publication 590, Appendix E. If you are recalculating your own life expectancy (single life), or the life expectancy of both you and your spouse (who is the designated beneficiary), these tables are relatively straightforward—you can just use the life expectancy factors indicated in the tables.

It gets more complicated, however, if you have chosen to use a joint life expectancy factor to determine minimum distributions. Assume, for example, you have chosen to recalculate your own life expectancy but not the life expectancy of your spouse, who is the designated beneficiary.

To calculate the appropriate factor, you should follow the method described by the Proposed Regs 1.408-8, using Tables V and VI mentioned above (in IRC Regs. 1.72-9). Here's how it works:

Let's assume the owner turned age 71 in 1995, his first required distribution year, and in the same year his spouse turned 68. It is now 1998, the fourth distribution year. The owner will use the normal joint life expectancy factor in Table VI of IRC Regs 1.72-9. However, although the owner will use his actual age, which is 74, he will use an 'adjusted age' for his spouse. Although the spouse's real age is 71, her 'adjusted age' is determined as follows:

- Determine the spouse's actual life expectancy, separately, for the year in which the owner reached age 70½. In this instance, the spouse's age in that year was 68, and the life expectancy at age 68 (based on Table V) is 17.6 years.
- Reduce the spouse's life expectancy by 1 for each year following the distribution year. In this instance, it has been three years, so the spouse's 'adjusted' life expectancy in year four is 14.6 (17.6 – 3).
- Determine the age in Table V that corresponds to a life expectancy factor of 14.6. If the result is between ages, always round up to the higher age. In this instance, in Table V a life expectancy factor of 14.6 corresponds to age 72. Therefore, in this example, the spouse's 'adjusted age' is 72.
- Go back to Table VI, which has the joint and survivor life expectancy factors, and find the factor based on the owner's age (in this example 74) and the spouse's adjusted age (here, 72). In this example the life expectancy factor under Table VI is 18.2 years. Thus, this year's required minimum distribution is the retirement plan balance divided by 18.2.

In this example, if the spouse dies before the owner, future distributions would nevertheless continue to be calculated as before, based on the 'adjusted age' of the spouse (ignoring the fact that she died, since the owner did not elect to recalculate the spouse's life expectancy) and the owner's actual age. If the owner dies first, future installments to the spouse will be calculated based on the number of years remaining in her original life expectancy (17.6 years

TABLE 1. WHO CAN RECALCULATE? THE CHOICES

Basis for Life Expectancy Factor	Owner recalculates life expectancy	Owner doesn't recalculate life expectancy	Designated beneficiary recalculates life expectancy	Designated beneficiary doesn't recalculate life expectancy
Single life—owner only				
	Yes	—	N/A	N/A
	—	Yes	N/A	N/A
Joint life—owner and spouse				
designated beneficiary	Yes	—	Yes	—
	Yes	—	—	Yes
	—	Yes	Yes	—
	—	Yes	—	Yes
Joint life—owner and non-spouse				
designated beneficiary	Yes	—	Not allowed	Yes
	—	Yes	Not allowed	Yes

in our example). Alternatively, the spouse may elect to roll the IRA balance into her own IRA and start a new minimum distribution strategy.

Easy, isn't it?!

IS RECALCULATING BENEFICIAL?

Question #3: Is it more beneficial to recalculate or not recalculate the life expectancy of the owner and/or the designated beneficiary?

Let's look at each alternative—

- Alternative 1: Recalculate the Owner/Don't Recalculate the Spouse (the Designated Beneficiary)

By recalculating one of the life expectancies during your lifetime, the required distributions will be less than if non-calculated life expectancies are used. But if you, the owner, die first, your life expectancy reduces to zero, which would cause the factor to be based only on your spouse's single life expectancy under the fixed-term (i.e., reduce by one, or don't recalculate) method. At that point, the result would be a larger minimum distribution requirement. However, with your spouse as the designated beneficiary, the spouse could roll the remaining IRA balance into his or her own IRA and elect a new minimum distribution strategy, involving a new designated beneficiary, to rectify the situation.

If the spouse dies first, the life expectancy factor is not impacted and distributions continue as before.

The broadest flexibility for extending minimum distributions both during the owner's lifetime and after the owner's death appears to be to name the spouse as designated beneficiary and to recalculate the owner's, but not the spouse's, life expectancy. This alternative also gives the surviving spouse access to this account during his or her entire lifetime, rather than naming children/grandchildren as the initial designated beneficiary, which would cut off the spouse from access to the account after the owner's death.

- Alternative 2: Recalculate the Owner/Recalculate the Spouse (the Designated Beneficiary)

If the owner dies first, the result is the same as in the first alternative: The surviving spouse could elect to roll the IRA into his/her own IRA to effect a 'fresh start' by naming a new designated beneficiary. This would reduce or eliminate the accelerated distributions that would otherwise be required at your death.

However, this alternative has worse results than Alternative 1 if your spouse dies first and you have passed your required beginning date (April 1 of the year following your 70½ birthday). At that point, you may not choose a new designated beneficiary for purposes of calculating minimum distributions. You are locked into using your own single life expectancy only, since your spouse's life expectancy drops to zero at death. If you have not reached your required beginning date, a new designated beneficiary can be named, which would lessen the impact of your spouse predeceasing you.

- Alternative 3: Recalculate the Owner/Don't Recalculate the Non-Spouse Designated Beneficiary

In this case, since the designated beneficiary is not your spouse, the minimum distribution incidental benefit (MDIB) rule comes into play during your lifetime. During your lifetime, the life expectancy factor would need to be calculated two ways each year. The regular method would be as described in Question #2 above, where you use your actual life expectancy, but an adjusted life expectancy for the designated beneficiary. The MDIB method requires that the regular method factor be compared to the 'applicable divisor' shown in the MDIB table in Proposed Reg. 1.401(a)(9)-2 Q&A 4(a) or in IRS Publication 590; the factor used must be the smaller of the two figures. In all cases, the MDIB factor is the smaller factor such that whether or not the owner recalculates his/her life expectancy, the value of the distributions during the owner's lifetime would be the same (see Table 2, columns D and E).

As in Alternative 1, if you die first, your life expectancy reduces to zero the year following your death, leaving the designated beneficiary with calculating a factor based only on the designated beneficiary's single life expectancy. Since the MDIB rules no longer apply at that point, the factor reverts to the designated beneficiary's actual life expectancy, reduced by the number of years that have passed since you began receiving distributions. This new factor could be considerably larger than the factor you used while you were alive and will reduce the required distributions while the designated beneficiary is alive; however, the required distributions are slightly larger during the surviving designated beneficiary's lifetime than under Alternative 4.

If the designated beneficiary dies first and you have not passed your required beginning date, a new designated beneficiary may be named. But if you have passed your required beginning date, the death of the designated beneficiary will not change the calculation of the factor under the MDIB rules. Even replacing the deceased designated beneficiary with an older designated beneficiary will not cause you to change the calculation of the life expectancy factor.

- Alternative 4: Don't Recalculate the Owner/Don't Recalculate the Non-Spouse Designated Beneficiary

As in Alternative 3, the MDIB rules will likely govern the required minimum distributions during your lifetime. If you die first, the only difference is that the life expectancy factor thereafter is based on the actual ages of you and your designated beneficiary, starting from the first year you

TABLE 2. COMPARING THE DISTRIBUTION OPTIONS: ANNUAL FACTORS AND DISTRIBUTIONS THROUGH YEAR 20

Assumptions:

- $100,000 beginning account balance
- 8% pretax rate of return on account assets
- Owner age 71, spouse age 71, daughter (non-spouse) age 35
- Owner dies before beneficiary at end of year 15
- Minimum distributions made at beginning of year

					Alternative 1		Alternative 3		Alternative 4	
	A		B		C		D		E	
					Joint Life w/Spouse					
	Single Life Exp		Single Life Exp		Recalculate Owner		Joint Life Expectancy w/Non-Spouse			
	Recalculation		No Recalculation		No Recalc Spouse		Owner Recalculates		No Recalc Owner	
Year	**Factor**	**Amount**	**Factor**	**Amount**	**Factor**	**Amount**	**Factor**	**Amount**	**Factor**	**Amount**
1	15.3	$6,536	15	$6,667	19.4	$5,155	25.3	$3,953	25.3	$3,953
2	14.6	6,914	14	7,200	18.5	5,537	24.4	4,251	24.4	4,251
3	13.9	7,306	13	7,776	17.3	6,049	23.5	4,572	23.5	4,572
4	13.2	7,711	12	8,398	16.5	6,454	22.7	4,894	22.7	4,894
5	12.5	8,128	11	9,070	15.4	7,015	21.8	5,261	21.8	5,261
6	11.9	8,483	10	9,796	14.7	7,422	20.9	5,655	20.9	5,655
7	11.2	8,916	9	10,579	13.7	8,016	20.1	6,047	20.1	6,047
8	10.6	9,266	8	11,426	12.7	8,657	19.2	6,496	19.2	6,496
9	10.0	9,607	7	12,339	11.8	9,270	18.4	6,940	18.4	6,940
10	9.5	9,830	6	13,327	10.8	10,012	17.6	7,410	17.6	7,410
11	8.9	10,139	5	14,393	10.1	10,492	16.8	7,907	16.8	7,907
12	8.4	10,298	4	15,544	9.2	11,208	16.0	8,433	16.0	8,433
13	7.9	10,418	3	16,788	8.4	11,816	15.3	8,929	15.3	8,929
14	7.4	10,491	2	18,131	7.6	12,426	14.5	9,511	14.5	9,511
15	6.9	10,510	1	19,581	7.0	12,653	13.8	10,048	13.8	10,048
16	6.5	10,302			0.0	81,990	32.3	4,301	32.5	4,274
17	6.1	10,032					31.3	4,645	31.5	4,616
18	5.7	9,694					30.3	5,016	30.5	4,985
19	5.3	9,285					29.3	5,417	29.5	5,384
20	5.0	8,624					28.3	5,851	28.5	5,815

began receiving required distributions, reduced by the number of years that have passed since the initial minimum distribution. This factor is slightly larger than the one calculated after the owner's death in Alternative 3, thereby requiring a slightly smaller distribution after the owner's death. In most cases where a non-spouse beneficiary is named, this option gives a better result following death than Alternative #3.

If the designated beneficiary dies first and you have not passed the required beginning date, as in Alternative 3, a new designated beneficiary may be named. If you have passed your required beginning date, a younger designated beneficiary cannot be named to reduce the distribution factor. And because the life expectancy factor calculation does not need to change (since the designated beneficiary's life expectancy was not being recalculated in the first place), no action is needed. However, for estate planning purposes, you will want to carefully consider the renaming of a beneficiary for your IRA.

If your spouse will not need access to the IRA funds after your death and a younger heir is chosen as designated beneficiary, this alternative will likely yield the least amount of required minimum distributions and greatest wealth accumulation potential for the family over the life of your heirs. However, these assets are subject to estate taxes when passing to non-spouse beneficiaries to the extent they exceed your unified credit amount.

To better understand the impact of naming a spouse or non-spouse as the designated beneficiary of your IRA, Table 2 shows the required factors that would be used in determining the minimum distributions for a 71-year-old owner whose spouse is age 71 and whose daughter is age 35. Other key assumptions in this example are noted in the table. Please note that the table reflects only 20 years, although in some of the cases, extended distributions could continue beyond 20 years.

Columns A and B assume the owner elects minimum distributions based only on single life expectancy; Column A reflects recalculation and Column B reflects no recalculation. Column C assumes the owner names his spouse as the designated beneficiary and elects to recalculate the owner's but not the spouse's life expectancy each year. Columns D and E reflect naming the daughter as designated beneficiary; the owner's life expectancy is recalculated in Column D but not in Column E, and in both columns the designated beneficiary's life expectancy is not recalculated (which is the only choice available).

WHAT ABOUT ROTH IRAs?

Question #4: Do these rules apply to Roth IRAs, too?

Minimum distributions from Roth IRAs are not required during the lifetime of the account's original owner. However after the owner's death, distributions must begin and are based on the same rules as for minimum distributions from all other IRAs, unless the owner's spouse is the beneficiary. In that case, the spouse may roll the Roth IRA into his/her own Roth IRA without any required distributions until the surviving spouse's death.

If you are contemplating converting a regular IRA to a Roth IRA, one of the criteria is that your adjusted gross income cannot exceed $100,000 in the year of conversion (excluding the taxable value of the IRA to be converted). On May 6, 1998, the Senate approved an amendment to the IRS restructuring bill (H.R. 2676) that excludes minimum distributions from adjusted gross income thresholds for determining eligibility to convert.

CONCLUSION

As you can see, the choice of whether or not to recalculate life expectancy can have subtle, yet important, implications on the future required minimum distributions from an IRA or qualified plan.

Understanding the results both during your lifetime and after your death should help you in making the choice that will be most beneficial to you and your family. As always, we suggest that you consult with a professional adviser knowledgeable about retirement planning issues who can assist you in analyzing your personal situation. ✦

QUICK REFERENCE GLOSSARY

Designated beneficiary: Defined by the IRS as an individual or 'qualified trust'; excludes your estate, charities or non-qualified trusts. See our June 1998 Retirement Plans column for in-depth discussion of a qualified trust.

RBD: Required beginning date—the date you are required by law to begin taking distributions from your qualified plans and IRAs. The RBD is April 1 of the year following your 70½ birthday, and it is critical for determining the impact of changing your beneficiary designations. Note that if you work beyond age 70½ for an employer with a qualified plan, your RBD for that qualified plan will differ from this general definition.

Owner: The individual who established and made contributions to the IRA.

IRA: For purposes of this article, reference to IRAs includes all company-sponsored qualified plans as well as your "individual retirement accounts." The rules for 401(k)s, Keoghs, defined-benefit plans and defined-contribution plans, etc., are consistent with those stated here.