RETIREMENT PLANS

The guiding principle in understanding the rules is that the decisions you make as of your required beginning date for minimum distributions are irrevocable.

Revisiting the Rules for IRA Distributions and Naming Beneficiaries

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For 1997, our series will begin by looking back to a complicated issue we addressed in 1996. Taking minimum distributions at age 70½ and the importance of choosing beneficiaries by the required beginning date raised several questions from AAII members.

Designated beneficiaries become important because your designation of a beneficiary affects the minimum required distribution amount that you must withdraw from your IRA, beginning no later than your required beginning date. Your required beginning date is April 1 of the year following the year you turn age 70½ for IRAs; under the tax changes last year, the required beginning date for company-sponsored retirement plans can be extended to the year following termination of employment, if later than age 70½.

Spouse as Beneficiary

Naming a spouse as beneficiary allows distributions to be calculated based on the joint life expectancies of both spouses. Furthermore, you can also recalculate the life expectancies of one or both spouses. This allows payments to be extended to as long as either of the owner or spouse lives, up to age 115. There is a price for the recalculation option, however, in that at the death of the *surviving* spouse, generally the IRA must be totally distributed in the year after the last death, resulting in an acceleration of income tax liability.

It is also important to note that the terms of your IRA agreement may govern this determination, since under the law, life expectancies must be recalculated unless the plan allows for a different option. Many, but not all IRA agreements permit you and your spouse to elect whether to recalculate one or both life expectancies, so check your agreement carefully. The election out of recalculation must be made by the required beginning date, and is irrevocable.

Non-Spouse Beneficiaries

Naming a non-spouse (child, grandchild, niece, nephew, etc.) as beneficiary also allows for distributions based on joint life expectancies, with two limitations:

(1) In determining the required minimum distribution, the non-spouse beneficiary is deemed to be no more than 10 years younger than the account owner, regardless of the beneficiary's actual age (this is the so-called minimum distribution incidental benefit—MDIB—rule). This rule does not apply to the account owner's spouse and does not apply after the account owner's death. Thus, after death it is possible to use a younger beneficiary's actual age to calculate required distributions.

(2) Although the owner can recalculate his or her life expectancy, the beneficiary's life expectancy is fixed—i.e., cannot be recalculated.

Naming a beneficiary that is not a person, such as an estate, non-qualifying trust or charity, requires that only the single life expectancy of the owner be used.

Example 1: Doc Holliday, age 70½, names his 15-year old nephew, Billy T. Kid, as beneficiary of his $500,000 IRA. The minimum required distribution in the first year is $19,084, determined by dividing $500,000 by a joint life expectancy of 26.2 years. [This factor is found in Internal Revenue Service Publication 590 or 939, using a life expectancy of age 70 for Doc and 60 for Billy, due to the MDIB rule. Note that in this example, Doc is assumed to be age 70 on December 31 in the year he turned 70½. It is possible that Doc could be age 71 in cases where he turned 70½ prior to July 1.] Also, while Doc can recalculate his life expectancy in each of the following years, Billy's life expectancy is reduced by one year in each subsequent year. If Doc recalculates and dies, his life expectancy is zero in the following year. However, assuming Doc did not recalculate and then dies 12 years later at age 81, Billy's payout is calculated over Doc and Billy's joint life expectancy determined without regard to the MDIB rules. Thus, in the year following Doc's death, Billy receives payments based on Doc's "life expectancy" (which was 16 when required distributions be-

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gan, and is now 16 – 12) and his own "life expectancy" (which was 66.8 when required distributions began, and is now 66.8 – 12). In other words, their life expectancies are fixed at the required beginning date, then reduced by one for each year a distribution is required. Finally, note that if Doc continues to live to age 95, Billy's life expectancy goes to zero, since the MDIB rules requires Billy be treated as if he were 60 when Doc began taking distributions. At age 60, life expectancy is 24.2; so Doc would be 94.2 (70 + 24.2) when his young nephew is considered dead for purposes of distributions during Doc's lifetime.

When Owner Recalculates and Beneficiary Doesn't

To calculate life expectancies, you must determine the life expectancy of the beneficiary in the first year, using the table for single life expectancies [Table V of Regulation 1.72-9, found in Internal Revenue Service Publication 590 or 939.] Once this is determined, it must be used, less one year, for every year following the year you turn 70½.

The first-year calculation is fairly straightforward: simply use the joint lives table (Table VI) for the actual ages of each person. In year two, go back to Table V to find the age of a person with the corresponding life expectancy you calculated in step one, and subtract one year. Use this age (rounded up to the next highest age, if necessary), as the beneficiary's age in the joint lives table. Once you learn how to do this, programming your VCR will be a piece of cake.

Example 2: Doc and Jane decide to recalculate his life expectancy but not hers. Assume Doc is age 71 for purposes of his minimum required distribution year and Jane is 69; Table VI gives a joint life expectancy of 20.7. At age 69, Jane's life expectancy is 16.8 years. In the following year, Doc is age 72, but to use the joint lives table, you must determine what age to use for Jane. Since Jane is not recalculating, her life expectancy in year two is 15.8 years (16.8 minus one year). Going to Table V for single life expectancies, we find that a single life expectancy of 15.8 years is attributable to a person between age 70 and 71. The rules require us to use the higher life expectancy, age 71, in the joint lives table. In year three, Jane's fixed life expectancy is 14.8, which corresponds to a person between age 71 and 72, so Jane would use age 72.

Replacing Beneficiaries

One area that deserves elaboration involves changing beneficiaries after distributions have begun. Several readers asked for clarification on the tax consequences of changing existing beneficiaries or replacing a beneficiary that dies before the account owner. The rules are as follows:

- Before your required beginning date you can change beneficiaries as often as you wish for whatever reason (including death of the original beneficiary).
- Once you pass your required beginning date, changes to beneficiary designations can have significant tax consequences.

Beneficiary Changes After the Required Beginning Date: The tax results depend on the circumstances. For example, if distributions are calculated using joint life expectancies and the original beneficiary dies before the owner, the original beneficiary's life expectancy continues to be used in determining the owner's required minimum distributions. This occurs regardless of the life expectancy of any replacement beneficiary. Thus, while you can replace a deceased beneficiary, it will have no effect on your minimum distribution calculations. Furthermore, if the deceased beneficiary was a spouse whose life expectancy was being recalculated, then that spouse's life expectancy is zero in all subsequent years.

What happens when a beneficiary is replaced with a new beneficiary, but it is not as a result of death? You continue to use the original beneficiary's life expectancy, unless the new beneficiary has a shorter life expectancy than the original beneficiary. In this case, you must use the shorter life expectancy. Life expectancies of new beneficiaries are first determined as of the required beginning date, and then reduced by the number of years that have passed since then.

In addition, if any beneficiary is replaced by a non-person (estate, charity, non-qualifying trust), zero is used as a life expectancy, since a non-person beneficiary has no life. Also, except in the case where the original beneficiary died, if no beneficiary is renamed as a replacement, the distributions will be calculated based on the single life expectancy of the owner.

If the life expectancy of the original beneficiary that was replaced is used during the life of the owner, what happens when the original beneficiary dies? It appears that if the original beneficiary was a spouse whose life expectancy was being recalculated, then the year following his or her death, the life expectancy used would be zero. Otherwise, if the life expectancy was not recalculated, then the death of the original beneficiary would have no impact.

What happens when the owner dies and a replacement beneficiary had been named? If the owner dies after the required beginning date, but before all amounts are distributed, then the remaining portion must be distributed at least as rapidly as under the distribution method being used as of the date of death. Therefore, distributions can continue based on the life expectancy of the original beneficiary, and if not being recalculated, the life expectancy of the owner. However, in the case of an older beneficiary replacing the original beneficiary, the older beneficiary's age must be used before and after the death of the owner. It is important to reiterate that the rule requiring a non-spouse beneficiary's life expectancy to be based on an age no younger than 10 years less than the owner does not apply after the death of the owner. Let's look at one more example of how this works.

Example 3: Referring back to Example 1, when Doc named Billy, age 15, as beneficiary, Doc's distributions were calculated as if Billy were age 60 due to the

MDIB rules. However, if Doc dies at age 75, Billy's life expectancy as of that date is 61.8 years. This is determined by using the single life expectancy table amount for Billy at age 15, less the five years that have passed. However, Billy's recalculated life expectancy will be used in the year following the year of death, so the factor is 60.8 (in the year of death, the distribution is calculated as if the deceased person were still living). If Doc were not recalculating, then the joint life expectancy table could be used until Doc would have been age 86 (his life expectancy at age 70 was 16 years, and 16 plus 70 is age 86).

Carved in Stone

The guiding principle in understanding the minimum required distribution rules, and replacing beneficiaries, is that your decisions at your required beginning date are *irrevocable:* They will continue to affect your required distributions throughout your lifetime, and they will continue to affect post-death distributions to your heirs.

Distributions to heirs may be no less than those required by the *method* in use at death, which will in most cases be the method chosen at your required beginning date.