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Ancient History

Minimum Required Distributions from Retirement Plans and IRAs
Under the IRS's 1987 and 2001 Proposed Regulations,
Assorted Grandfather Rules, and Other Almost-obsolete Rules Applicable to
Life and Death Planning for Retirement Benefits

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This Special Report is a supplement to my book *Life and Death Planning for Retirement Benefits*. The book covers *today's* minimum distribution, income tax, and other rules that affect individuals' planning decisions (and compliance) for their IRAs, Roth IRAs, and retirement plans.

This Special Report contains information about various "grandfather rules" that are *no longer available* to most participants and beneficiaries, but might still be of benefit to a small number of individuals.

This Report also explains how required minimum distribution rules were computed under proposed IRS regulations issued in 1987 and 2001. While these old versions of the rules cannot be used to compute required distributions after 2002, the material here may help you compute missed MRDs for years prior to 2003.

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WARNING AND DISCLAIMER!

This "Special Report" entitled *Ancient History* contains material that is, for most people, out of date. The rules discussed in this paper are generally NOT applicable to today's retirement benefits. PARTS I–IV discuss "grandfather rules" that apply *to a small number of individuals who qualify for them*; other people cannot use these rules. PARTS V–VI explain minimum distribution rules that applied *for years before 2003*; these rules cannot be used to compute minimum distributions today.

The material produced here is taken, without change, from older versions of seminar materials and other publications that were current when produced. These materials have NOT been updated or reviewed, due to their out of date nature. Accordingly, this Special Report is intended to be helpful to practitioners solely as a starting point for their own research in advising their clients regarding "grandfathered" benefits and in computing minimum required distributions for years prior to 2003.

PART I: ESTATE TAX EXCLUSION: SEPARATION FROM SERVICE PRIOR TO 1985

This PART I explains the requirements for obtaining a partial or total exclusion of retirement benefits from the federal gross estate for estate tax purposes. This should be reviewed with respect to any decedent whose estate is subject to federal estate tax and who owns retirement benefits under the plan of an employer from whose service the decedent separated prior to 1985.

4.3.08 ***The federal estate tax exclusion lives!***

Once upon a time, § 2039 provided an unlimited federal estate tax exclusion for most kinds of retirement benefits. The exclusion was reduced to $100,000 by TEFRA (1982) and repealed by TRA '84. However a grandfather clause was included in TRA '84 for both laws; then § 1852(e)(3) of TRA '86 made significant amendments to these grandfather clauses. The TRA '86 changes applied to qualified retirement plans (QRPs), were retroactive, and made it much easier to qualify for the exclusion (with respect to QRP benefits) than it was under the original grandfather provision in TRA '84.

However, no regulations were issued after the TRA '86 amendments. The casual researcher may find only the strict TRA '84 grandfather rules (as embodied in IRS Temp. Reg. § 20.2039-1T, 1986) under which only participants who were "in pay status" and had "irrevocably elected a form of benefits" by 1982 or 1984 still qualified for the exclusion. These strict standards still apply to an IRAs for which the exclusion is claimed. Rev. Rul. 92-22, 1992-1 C.B. 313. But TRA '86 simply *repealed* those two requirements with respect to QRP benefits and substituted others. Thus Temp. Reg. § 20.2039-1T is nugatory for QRP benefits, though it may still be useful with respect to IRA benefits.

The best explanation of this tangle appears in PLR 9221030. The current requirements for a decedent's estate to be eligible for a total (or $100,000) estate tax exclusion, as stated by the IRS in this ruling, are, for a qualified plan:

1. A decedent who separated from service before 1983, and dies after 1984, without having changed the "form of benefit" before his death, will be entitled to 100 percent exclusion of the benefit. A change of *beneficiary* is fine; it is a change of the *form of payment* of the benefit that triggers loss of the exclusion.

2. If the decedent separated from service after 1982 but prior to 1985, and did not change the form of benefit between the time of separation from service and the time of death, the estate is still entitled to the exclusion but it is limited to $100,000.

Both of these exclusions under the retroactive amended grandfather clause are available for a QRP *regardless* of whether the election of form of benefits was irrevocable, and *regardless* of whether the benefits were "in pay status" on December 31, 1984 or any other particular date.

For an IRA, the requirements are stricter, since the TRA '86 retroactive amendments of the grandfather clause did not apply to IRAs. Rev. Rul. 92-22, 1992-1 C.B. 313. For an IRA the exclusions is available only if the decedent had:

1. Irrevocably elected a form of benefit before July 18, 1984 (with no changes in the form of benefit after that date); and

2. Was in pay status as of December 31, 1984.

The IRS's Instructions for Form 706 (Schedule I) (Aug. 2008) contain extensive material regarding the requirements for excluding retirement plans and IRAs from the gross estate.

PART II: SPECIAL INCOME AVERAGING: PARTICIPANT BORN BEFORE 1936

A qualified retirement plan participant who was born before 1936 may be entitled to a "special averaging" method of computing the income tax on a lump sum distribution he receives from the plan. The beneficiaries of a deceased participant may similarly be entitled to use the "special averaging" method of computing income tax on a lump sum distribution they receive from the qualified retirement plan if the deceased participant was born before 1936.

2.4.06 ***Special averaging: Participant born before 1936***

If an LSD meets certain additional requirements, the LSD can be taxed separately, using "10-year averaging" and "20 percent capital gain." These two special tax deals are referred to collectively as the "special averaging method." An LSD for which a proper election is made to use these methods is excluded from the recipient's adjusted gross income (AGI), and is instead taxed using special rates. § 402(d)(3); § 62(a)(8). (These Code sections have been repealed for years after 1999, but still apply under the "transition rule" that "grandfathers" participants born before 1936; see effective dates for amendments to § 62 and § 402).

A. Exclusion from income. The fact that an LSD for which special averaging is elected is excluded from AGI can be beneficial, but it can also create problems.

On the good side, it means the distribution will not be included in AGI for purposes of: the income limits for obtaining a Roth IRA; the threshold for deducting medical expenses (7.5% of AGI; § 213(a)); the threshold for reduction of itemized deductions by a percentage of "excess" AGI (§ 68); the threshold for reducing personal exemptions (§151(d)(3)); or determining how much of the recipient's Social Security benefits will be subject to income tax under § 86. On the negative side, the exclusion of the LSD from AGI may reduce the client's ability to deduct large charitable gifts; the charitable deduction is limited to a certain percentage of AGI. § 170(b).

B. Tax using 10-year averaging. Here is how to determine the tax under the 10-year averaging method:

(i) Divide the LSD by 10.

(ii) Determine the tax on 10 percent of the LSD using 1986 rates applicable to single taxpayers (conveniently reproduced in the instructions to IRS Form 4972).

(iii) Multiply the amount obtained in step (ii) by 10. The result is the 10-year averaging tax applicable to the distribution.

Although maximum tax rates were higher in 1986 than they are now, the effect of the 10-year averaging calculation is to tax the distribution as if it were 10 small distributions rather than one big distribution. The result can be dramatically lower-than-usual taxes, especially on smaller LSDs. A "minimum distribution allowance" produces an even lower tax on distributions under $70,000; see Form 4972.

Note: No tax is paid currently on the value of certain annuity contracts included in the distribution, though the value is still counted as part of the LSD. Also, the above method determines the tax on the "ordinary income" portion of the LSD. See "C" for possible capital gain treatment of part of the distribution.

C. "Capital gain" portion. If the participant was born before 1936, and was a participant in the plan prior to 1974, part of the LSD for which the "special averaging method" has been elected is eligible to be treated as a "capital gain" taxed at 20 percent. This 20 percent rate applies without regard to the actual tax rate on capital gain in any particular year.

Prop. Reg. § 1.402(e)-2(d) provides that the "capital gain" portion of the distribution is determined by deducting the "ordinary income portion" (OIP) from the "total taxable amount" (TTA). The OIP is determined by multiplying the TTA by the following fraction:

Numerator:	Calendar years of active participation after 1973.
Denominator:	Total calendar years of active participation.

In the case of pre-1974 years, the employee gets twelve months' credit for each calendar year or partial calendar year of participation. For post-1973 years, he gets one *month's* credit for each calendar month or part of a month in which he is an active participant.

With smaller distributions, the 20 percent "capital gain method" may produce a higher tax than would apply under 10-year averaging. In this case, the participant can elect to have his capital gain portion treated as ordinary income; or rather, technically, to "treat pre-1974 participation as post-1973 participation." See § 402(e)(4)(L) as it existed prior to repeal by TAMRA '88 § 1011A(b)(8)(G). If this election is made, the 20 percent treatment is waived and the entire distribution is taxed under 10-year averaging.

Mike Jones on LSD Anomalies

Mike Jones, CPA *extrordinaire*, offers the following observations about the special averaging treatment of LSDs:

1. Special averaging treatment for an LSD is the only occasion in the Code when a trust or estate gets to use the *individual* income tax rate schedule rather than trust rates.

2. The exclusion from income means a client can receive (say) a $100,000 LSD, elect special averaging, pay $14,471 of income tax, donate the $100,000 to charity, and (subject to the limits in § 170(b)) take a deduction of $100,000 from his *ordinary* income.

3. On the negative side, if the LSD is subject to state income tax, it may generate a large deduction for state income tax, which in turn may make the taxpayer subject to the alternative minimum tax if the LSD is excluded from AGI.

2.4.07 ***Eligibility for special averaging method***

The special averaging method is available only for individuals "who attained age 50 before 1 - 1 - 86." TRA '86 § 1122(h)(3), (5), (6), as amended by TAMRA '88, § 1011A(b), (13)–(15). The IRS interprets this as applying to anyone born before January 2, 1936; see IRS Form 4972 (2007), lines 3–4. Special averaging may be elected only once with respect to a taxpayer. It must be elected for all lump sum distributions in the same year that qualify for it. *Special averaging cannot be used if any portion of the distribution is rolled over.* The LSD will be subject to mandatory 20 percent income tax withholding. Other requirements are listed in Part I of Form 4972 (2008), which can be used as a checklist to determine qualification.

Only individuals, estates, and trusts can elect (by filing Form 4972) the special averaging method. A distribution to a partnership or corporation will not qualify; see former § 402(d)(4)(B). For more details on how to calculate the tax under the special averaging method, see ¶ 2.4.08–¶ 2.4.11 of the 5th edition (2003) of this book, or the *Special Report: Ancient History*, downloadable at www.ataxplan.com.

The 10-year averaging and 20 percent capital gain tax grandfather rules were not repealed by EGTRRA and thus will continue to be available indefinitely for LSDs of benefits of employees born before January 2, 1936; however, EGTRRA did add one new limitation. EGTRRA substantially liberalized the rollover rules. Congress intended the new rollover rules to increase the "portability" of pensions, not to increase the amounts eligible for ancient grandfather rules. Accordingly, EGTRRA § 641(f)(3) provides that the benefits of TRA '86 § 1122(h) "shall not apply" to a distribution from an otherwise-eligible retirement plan "if there was a rollover to such plan on behalf of such individual which is permitted solely by reason of any amendment made by this section." Like the new rollover rules themselves, this limitation is permanent as a result of PPA '06.

PART III: MINIMUM DISTRIBUTIONS: PRE-1984 TEFRA 242(b) DESIGNATIONS

The minimum distribution rules of § 401(a)(9) apply to most people, but may NOT apply to the benefits of a plan participant who filed a special form of "designation" with the retirement plan prior to 1984. The special form of designation is called a "TEFRA 242(b) election."

1.4.10 ***Grandfather rule: TEFRA 242(b) elections***

TEFRA (1982) significantly expanded the minimum distribution rules. For years after 1983, § 401(a)(9) would apply to *all* QRPs (previously it had applied only to Keogh plans). Under the pre-TEFRA rules, no distributions were required prior to retirement; TEFRA (and the Tax Reform Act of 1984, "TRA '84," which "cleaned up" the TEFRA changes via many retroactive amendments) added a requirement that 5-percent owners would have to start distributions at age 70½ even if still employed. TEFRA also added requirements for post-death distributions (there had been none previously).

TEFRA contained a grandfather rule, § 242(b)(2), which provided that a plan will not be disqualified "by reason of distributions under a designation (before January 1, 1984) by any employee of a method of distribution...(A) which does not meet the requirements of [§ 401(a)(9)], but (B) which would not have disqualified such [plan] under [§ 401(a)(9)] as in effect before the amendment" made by TEFRA. TRA '84 continued the TEFRA grandfather rule: The TRA '84 changes would not apply to "distributions under a designation (before January 1, 1984) by any employee in accordance with a designation described in section 242(b)(2) of [TEFRA] (as in effect before the amendments made by this Act)." TRA '84, § 521(d)(2)-5. The minimum distribution regulations provide special MRD rules for those with TEFRA 242(b) elections. Reg. § 1.401(a)(9)-8, A-13–A-16.

As a result of the many changes brought by TEFRA, there was a flurry of activity among sophisticated plan participants trying to make a "designation" by December 31, 1983 that would enable them to continue to use the older, more liberal rules. Theoretically, participants with TEFRA 242(b) elections in effect can postpone the start of MRDs past age 70½, until retirement (even if they own more than 5 percent of the employer), and their death benefits are not subject to the "5-year rule" (¶ 1.5.06) or the "at-least-as-rapidly" rule (§ 401(a)(9)(B)(i)). Unfortunately, TEFRA 242(b) elections have not proved as useful as originally expected for several reasons:

1. The requirements for a valid election, as set forth in Notice 83-23, 1983-2 C.B. 418, are quite restrictive: "The designation must, in and of itself, provide sufficient information to fix the timing, and the formula for the definite determination, of plan payments. The designation must be complete and not allow further choice." P. 419. This does not mean the designation may not be amendable or revocable. Rather, the designation must be self-executing, requiring no further actions or designations by the participant to determine the size and date of distributions. Some purported TEFRA 242(b) elections do not meet this test.

2. Rolling over QRP benefits protected by a 242(b) election into an IRA causes loss of the 242(b) protection. However, grandfather protection is not lost if benefits are moved to another

QRP without any election on the part of the participant (for example, as a result of a plan merger), if the transferee plan accounts for such benefits separately. Reg. § 1.401(a)(9)-8, A-14, A-15.

3. TEFRA 242(b) elections generally attempted to defer distributions for as long as possible. This turned out to be counterproductive, because an unrealistically long proposed deferral made it more likely that a participant who had made a 242(b) election would want to make withdrawals sooner than his "designation" indicates. However, "any change in the designation will be considered to be a revocation of the designation." Notice 83-23, p. 420.

4. If the 242(b) election is revoked, drastic results ensue. In effect the grandfathered status is revoked. The participant is required to start taking MRDs in accordance with current rules, *and* he is required to take make-up distributions—withdraw from the plan all the prior years' distributions he had skipped (though no penalty applies). Reg. § 1.401(a)(9)-8, A-16. See ¶ 1.9.04 regarding how to compute MRDs for past years.

Thus, a participant relying on a TEFRA 242(b) election lives in a perilous state. The longer he defers his distributions, the larger becomes the make-up distribution that will be required if he ever changes his mind and modifies the designation.

An over-age-70½ participant whose TEFRA 242(b) election called for a lump sum distribution of the benefits at retirement can retire, take the lump sum, roll it over to an IRA, and commence taking MRDs from the IRA in the normal fashion, without being required to take make-up distributions. PLR 2005-10035. If his election had called for instalment or annuity payments rather than a lump sum, taking a lump sum would presumably be considered a modification, but there are no rulings on this point.

PART IV: MINIMUM DISTRIBUTIONS: PRE-1987 403(b) PLAN BALANCES

The minimum distribution rules of § 401(a)(9) apply to most people, but may NOT apply to the pre-1987 benefits of 403(b) plan participant. This PART IV explains the rules that do apply to such benefits, who qualifies for the grandfather rule, and planning considerations. PART IV(A) contains, verbatim, the discussion of this topic from pages 230–238 of the first (1996) edition of *Life and Death Planning for Retirement Benefits*. PART IV(B) contains, verbatim, the discussion of this topic from pages 382–386 of 1999 edition of *Life and Death Planning for Retirement Benefits*.

A. From the 1996 edition of *Life and Death Planning for Retirement Benefits*:

Pre-1987 403(b) Plan Balances

403(b) plans partly grandfathered from minimum distribution rules....

At one time, 403(b) plans (see Glossary) were exempt from most of the "minimum distribution rules." The Tax Reform Act of 1986 made these plans subject to the minimum distribution rules on the same basis as other plans. TRA '86 s.1852(a)(3)(A) added s. 403(b)(10) which provides that "under regulations prescribed by the Secretary" a 403(b) plan will lose its tax-favored qualities "unless requirements similar to Section 401(a)(9) are met (and requirements similar to the incidental death benefit requirements of Section 401(a) are met)." This amendment was to apply "as if" included in the Tax Reform Act of 1984 (see section 1881 of TRA-'86), because it was considered a technical correction of TRA-'84.

Prop. Reg. S. 1.403(b)-2 (7/27/87) governs these distributions. These proposed regulations refer to 403(b) annuities and mutual fund-custodial accounts collectively as "403(b) contracts." The regs. Say that 403(b) annuities and custodial accounts will be treated the same as individual retirement annuities under 408(b) and individual retirement accounts under 408(a), respectively, and accordingly the minimum distribution rules will be the same as for IRAs under proposed regulation 1.408-8. However, certain *plan participants* and *plan balances* are "grandfathered":

(a) Transition rule for older participants still working

There is a "transition rule" for 403(b) *plan participants* who turned age 70½ before 1988. These participants do not have to commence withdrawals from *any* part of their 403(b) plans until April 1 of the year following the year in which they retire. Notice 88-39, 1988-1 C.B. 525. These participants are in the same situation as the "hardworking aged non-5% owners" discussed in the previous section.

(b) Grandfathering of pre-'87 balance

The grandfathering for certain *plan balances* is available regardless of the participant's age. The *amount* that is grandfathered is the account balance on December 31, 1986 – *provided* that the plan sponsor/custodian keeps records that enable it "to identify the pre-'87 account balance and subsequent changes as set forth in" the regulations. (These regulations pertain to whether withdrawals made over the years from the 403(b) arrangement come out of the pre-'87 or post-'86 account balance). "If the issuer does not keep such records, the entire account balance" is subject to the full panoply of minimum distribution rules.

...But still subject to the MDIB rule

Even though pre-'87 balances are not subject to the so-called "minimum distribution rules" of s. 401(a)(9) of the Code, they are still subject to the "incidental death benefit" rule, which pre-dated the 1986 tax act.

Thus, any 403(b) plan, if the custodian keeps proper records, contains two portions: the December 31, 1986 account balance (as reduced by subsequent distributions); and the post-'86 account balance, which consists of post-'86, contributions, earnings on post-'86 contributions, and earnings on pre-'87 contributions (minus distributions therefrom). These two different portions are subject to two different sets of distribution rules. The post-'86 balance is subject to all the minimum distribution rules of 401(a)(9) and to the "minimum distribution incidental benefit" (MDIB) rule, which is the modern version of the "incidental death benefit" rule. The pre-'87 account balance is subject only to the MDIB rule.

The IRS tells us in proposed regulation 1.403(b)-2, Q & A-3, that the pre-'87 account balance "must satisfy the MDIB rule contained in Q & A-2 of s. 1.401(a)(9)-2." That Q & A, in turn, tells us that the distribution of benefits "must satisfy either the rules in effect as of 7/27/87 [the date the proposed regulation was issued] interpreting s. 1.401-1(b)(1)(i)," or "the rules in Q & A-3 through Q & A-7."

So, there are two ways to comply with the MDIB rule with respect to the pre-'87 balance in a 403(b) plan. One is to comply with the incidental death benefit rule as it existed prior to TRA '86. The other is to comply with the *new* minimum distribution rules, as tightened up by TRA '86. Use of the new rules would eliminate any benefit of being "grandfathered," but may appeal to some participants as being easier than trying to figure out what the "grandfather rule" allows.

What was the MDIB rule prior to 1986?

To discover what the older version of the MDIB rule was, we first look at the referenced regulation, s. 1.401-1(b)(1)(i). This old regulation is simply a general rule defining what a "pension plan" is. It is a plan maintained "primarily to provide systemically for the payment" of benefits to the employee after retirement; and it "may also provide for the payment of incidental death benefits." Commerce Clearing House interprets the old regulation as follows: "The IRS maintained that these definitions imposed a requirement that benefits payable to the beneficiary of an employee in a qualified pension or profit sharing plan be *incidental* to the primary purpose of distributing accumulated funds *to the employee*." CCH 1994 Standard Federal Tax Reports para. 17,726.04 [emphasis added].

Since the cited regulation is not particularly enlightening regarding any requirement for distributions *during life*, we must look at the "rules interpreting" that regulation at the time the proposed regulations were issued (7/27/87). These are contained in Rev. Ruls. 72-241 and 72-240, 1972-1 C.B. 108.

The incidental death benefit rule, pre-1987, was nowhere near as specific and stringent as today's minimum distribution rules. It did not require distribution at any particular age – only that distributions must begin at the "normal retirement age" specified in the plan, or, if later, at actual retirement. Also, unlike today's rules, the rule had no application after the death of the participant. All the old rule required was that:

> (a) Distributions must begin to the participant by "normal retirement age," or actual retirement if later.
>
> (b) When distributions commenced, if any form of installment or annuity payout was elected, the actuarial value of the participant's expected lifetime distributions had to be at least 50% of the total value of the benefits; *i.e.,* the expected death benefits had to be less than 50% of the total value.

Was there a separate MDIB rule for 403(b) plans?

Under s. 403(b), the employer does not typically adopt any retirement "plan" *per se*; the employer simply buys annuity contracts (or contributes money to mutual fund custodial accounts) for individual employees. Thus, unlike a "qualified" 401(a) pension or profit sharing plan, a 403(b) arrangement would not necessarily have a formal definition of "normal retirement age." Thus, the required distribution date that applied to qualified retirement plans under the "incidental benefit rule" ("normal retirement age," or actual retirement if later) could not be applied to 403(b) arrangements without some modification. There is some evidence that "age 75" was used as a substitute for "normal retirement age" in applying the "incidental benefit rule" to 403(b) arrangements prior to TRA '86. See Ltr. Ruls. 7825010, 7913129.

A more recent ruling apparently indicates that, whatever the rule may really have been prior to 1986, the IRS's position now is that age 75 is and always has been the outer limit. Ltr. Rul. 9345044 (8/16/93) contains the statement, "In general, regarding pre-1987 account balances, the IRS has generally interpreted the requirement that benefits in retirement arrangements be used primarily for retirement purposes to mean that annuity payments from tax-sheltered arrangements will begin no later than age 75." Contrary to this statement, however, the two earlier rulings cited above made no reference to such a concept or to the "incidental benefit rule."

Furthermore, if letter rulings are to be our source of guidance, the IRS's requirement seems to have been that payments must commence at retirement *or age 75, whichever is later*, at least in some cases (Ltr. Rul. 7913129, 12/29/78). This interpretation is consistent with the only "official" pre-1987 statement of the rule, namely, that a pension plan's primary purpose is to provide benefits to the employee *after retirement*. Reg. s. 1.401-1(b)(1)(i). It is also consistent with the "grandfather rule" which allows 403(b) participants who turned age 70½ before 1988 to defer distributions until actual retirement; it would be unusual to give "grandfathered" individuals a better deal under the "grandfather" rule than they had prior to the new legislation they are "grandfathered" from. (It is unusual but not unheard of – see "Lump Sum Distributions: the Rewards" section of Chapter 2.)

So is age 75 (or actual retirement if later) the required beginning date for 403(b) plan pre-'87 balances? There is no authority for this conclusion other than private letter rulings. It is quite possible that some employers obtained IRS approval, pre-1987, for 403(b) arrangements with earlier or later ages for required commencement of benefits. Nevertheless, this statement of the "incidental death benefit rule for pre-'87 account balances" seems to be now accepted. See Krass, Stephan J., Esq., *The Pension Answer Book* (10th ed., Panel Publishers 1995), Q29:40, p. 29-44.

This tortuous discussion of the incidental death benefit rule leads to the following tenuous conclusions.

Distribution or pre-'87 balance can be postponed until actual retirement

Until actual retirement, a 403(b) participant is not required to make ANY withdrawals from his grandfathered (pre-'87) balance. Accordingly, the annual minimum distributions that begin at the participant's required beginning date (April 1 following the year the participant turns 70½) should be calculated using only the post-'86 balance. Furthermore, it is advisable to withdraw only the *minimum* required amount each year from a grandfathered 403(b) plan. If more money is needed in a particular year, it should be drawn out of some other plan, because any amounts taken out of a 403(b) plan in excess of the required minimum distribution are deemed to come out of the grandfathered balance.

Consider naming credit shelter trust as beneficiary of 403(b) plans, if needed to bring funding up to $600,000

In general, it is preferable to fund a "credit shelter trust" with assets other than retirement benefits. See Chapter 2. For many working people, however, the only way to fully fund a $600,000 credit shelter trust is to use some retirement benefits for this purpose. In such a situation, it may be more favorable to use a 403(b) plan which contains a "grandfathered" balance than to use some other retirement plan that is fully subject to the "minimum distribution rules."

If a plan that is fully subject to the minimum distribution rules is made payable to the participant's credit shelter trust, the trustee of the credit shelter trust will in most cases be required to draw out from the plan, every year, an installment which (after some years) will include plan "principal" as well as "income." The principal that is taken out of the plan and placed in the credit shelter trust will be subject to high trust income tax rates (39.6% on taxable income above $7,650) (1995 rates). (See discussion of trust income taxes in Chapter 2.)

If 403(b) benefits are made payable to the credit shelter trust, by way of contrast, there would be no requirement for distributing any particular amount at any particular time after the participant's death from the pre-'87 account balance. See Ltr. Rul. 7825010 (3/21/78). The trust would have to withdraw the amounts required by the minimum distribution rules from the post-'86 balance (which includes the earnings on the pre-'87 balance), but would never have to touch the principal of the pre-'87 balance.

If the pre-'87 balance is preserved intact inside the plan until the death of both spouses, it could then be distributed to the children and taxed at their personal income tax brackets. Thus, if a client must use retirement plan death benefits to "fill up" a credit shelter trust, it is better to use a 403(b) plan with a hefty pre-'87 balance for this purpose, and make *other* plans payable to the spouse personally.

An intriguing question is whether it is possible to make the pre-'87 balance payable to one beneficiary (*e.g.*, the credit shelter trust) and the post-'86 balance payable to another (*e.g.*, the spouse).

Recommendations for 403(b) plans

A 403(b) plan participant who has reached age 70½, but not yet retired, might adopt the following program:

(a) From the custodian or administrator, obtain a statement verifying that it has a method for identifying the pre-'87 balance in accordance with regulations. If the custodian is complying with this requirement, the pre-'87 balance should be showing up as a separate item on all account statements.

(b) Figure out how much retirement plan money (if any) must be paid to the client's credit shelter trust in order for it to use up the entire federal estate tax exemption amount, then figure out which 403(b) plans have the highest relative proportion of pre-'87 balance and use those to "fill up" the credit shelter trust in the following manner. Name the participant's credit shelter trust as "designated beneficiary" for the selected plans, give a copy of the credit shelter trust to the plan administrator, and begin withdrawals, from the post-'86 balance *only*, over the joint life expectancy of the client (participant) and the oldest beneficiary of the credit shelter trust.

(c) Notify the custodian that the client does not intend to make any withdrawals from the pre-'87 balance until actual retirement (or age 75, if later).

Once retirement occurs, what distributions must come out of the pre-'87 balance?

Either at the "normal retirement date" specified in the plan (if one is specified), or possibly at age 75 if no other "normal retirement age" is specified, or upon actual retirement if later, a 403(b) plan participant should set up a payment schedule from the pre-'87 balance which is designed to pay to him, during his life expectancy, more than 50% of the actuarial value of the pre-'87 balance. This is the "incidental benefit rule" as it existed pre-'87. For the possibility that the 50% requirement may not apply if the participant's spouse is the beneficiary, or if the payout period is limited to the lives/life expectancies of the participant and spouse, see Rev. Rul. 72-240, previously cited, and Ltr. Rul. 7825010.

B. From the 1996 edition of *Life and Death Planning for Retirement Benefits*:

Pre-1987 403(b) plan balances grandfathered...

At one time, 403(b) plans were exempt from most of the minimum distribution rules. The Tax Reform Act of 1986 made these plans subject to the minimum distribution rules on the same basis as other plans. TRA '86 § 1852(a)(3)(A) added § 403(b)(10), which provides that, "under regulations prescribed by the Secretary," a 403(b) plan will lose its tax-favored qualities "unless requirements similar to" § 401(a)(9) and the incidental death benefit requirements of § 401(a) are met. This amendment was to apply "as if" included in the Tax Reform Act of 1984 (see § 1881 of TRA '86, because it was considered a technical correction of TRA '84.

Prop. Reg. § 1.403(b)-2 (7/27/87) governs these distributions. The regulation says that § 403(b) annuities and 403(b)(7) mutual fund custodial accounts (described collectively as "403(b) contracts") will be treated the same as individual retirement annuities under § 408(b) and individual retirement accounts under § 408(a), respectively, and accordingly the minimum distribution rules will be the same as for IRAs under Prop. Reg. § 1.408-8. However, certain *plan participants* and *plan balances* are "grandfathered":

(a) Transition rule for older participants still working

There is a "transition rule" for 403(b) *plan participants* who turned age 70½ before 1988. These participants do not have to commence withdrawals from *any* part of their 403(b) plans until April 1 of the year following the year in which they retire. Notice 88-39, 1988-1 C.B. 525. These participants are in the same situation as the "hardworking aged non-5% owners" discussed in the previous section.

(b) Grandfathering of pre-'87 balance

The grandfathering for certain *plan balances* is available regardless of P's age. The *amount* that is grandfathered is the account balance on December 31, 1986, *provided* that the plan sponsor/custodian keeps records that enable it "to identify the pre-'87 account balance and subsequent changes as set forth in" the regulations. (These regulations pertain to whether withdrawals made over the years from the 403(a) or (b) arrangement come out of the pre-'87 or post-'86 account balance). "If the issuer does not keep such records, the entire account balance" is subject to the full panoply of minimum distribution rules.

...But still subject to the MDIB rule

Even though pre-'87 balances are not subject to the so-called "minimum distribution rules" of § 401(a)(9) of the Code, they are still subject to the "incidental death benefit" rule, which predated the 1986 tax act.

Thus, any 403(b) plan, if the custodian keeps proper records, contains two portions: the December 31, 1986 account balance (as reduced by subsequent distributions); and the post-'86 account balance, which consists of post-'86 contributions, earnings on post-'86 contributions, and earnings on pre-'87 contributions (minus distributions therefrom). Theoretically, these two different portions are subject to two different sets of distribution rules: The post-'86 balance is subject to all the minimum distribution rules of § 401(a)(9) and to the "minimum distribution incidental benefit" (MDIB) rule, which is the modern version of the "incidental death benefit" rule. The pre-'87 account balance is subject only to the "incidental death benefit" rule.

The earlier (1996) edition of this book contained a lengthy discussion of exactly what rules governed the pre-'87 account balance of a participant's 403(b) plan, and the planning implications of this grandfather rule. Since 1996, however, the possible significance of this grandfather rule has diminished considerably, for several reasons:

1. Until retirement, a 403(b) participant is not required to make any withdrawals from his "grandfathered" (pre-'87) balance. However, with enactment of the Taxpayer Relief Act of 1997, *any* employee who is not a 5% owner of the sponsoring employer can postpone required distributions until retirement. Since 403(b) plans are by definition maintained by not-for-profit employers (which are not "owned" by anyone) it appears that 403(b) plan participants should be entitled to postpone distributions until actual retirement as to *all* of their 403(b) plan balances, regardless of whether they qualify for the pre-'87 grandfather rule.

2. The pre-'87 grandfather amount is a frozen fixed-dollar amount; investment earnings and gains do not increase the grandfathered balance (though distributions in excess of required distributions decrease it). With the passage of time, additional contributions to the plan, and investment growth, the pre-1987 balance becomes a smaller and smaller percentage of the overall plan balance. This makes it less of a concern in P's planning.

What special rules still apply to the pre-'87 balance?

The special rules applicable to the pre-'87 balance, not available to the post-1986 balance are:

1. Once a participant has retired, he should be able to postpone distributions on his pre-1987 balance until age 75 (see PLRs 7825010, 7913129 (12/29/78), and 9345044 (8/16/93); Reg. § 1.401-1(b)(1)(i); and Krass, Stephan J., Esq., *The Pension Answer Book* (10th ed., Panel Publishers 1995), Q29:40, p. 29-44). For the post-1986 balance, age 70½ is the trigger age for post-retirement required distributions.

2. When required distributions begin, the post-1986 balance is subject to the regular minimum distribution rules of § 401(a)(9), whereas the pre-1987 balance can be distributed in accordance with the pre-1987 "incidental death benefit rule." This rule was nowhere near as specific and stringent as today's minimum distribution rules. All the old rule required when distributions commenced was that, if any form of installment or annuity payout were elected, the actuarial value of P's expected lifetime distributions had to be at least 50% of the total value of the benefits; *i.e.,* the expected death benefits had to be less than 50% of the total value. Rev. Ruls. 72-241 and 72-240, 1972-1 C.B. 108. For the possibility that even this 50% requirement may not apply if P's spouse is the beneficiary, or if the payout period is limited to the lives/life expectancies of P and spouse, see Rev. Rul. 72-240, previously cited, and PLR 7825010.

3. Also, unlike today's rules, the old rule had no application after the death of P. Thus, if a 403(b) participant dies before the required beginning date applicable to his pre-1987 balance, theoretically the pre-1987 balance does not have to be distributed at any particular time to the beneficiaries. There is no five year rule and no requirement that the beneficiary take distributions over the beneficiary's life expectancy.

PART V: MINIMUM DISTRIBUTIONS UNDER 1987 PROPOSED REGULATIONS

This PART V explains the minimum distribution rules that then existed under the IRS's 1987 proposed minimum distribution regulations. It is excerpted from the author's book *Life and Death Planning for Retirement Benefits* (Ataxplan Publications, 3d ed. 1999). Cross references may refer to other portions of that edition of the book not reproduced here.

Understanding the Minimum Distribution Rules

Meet § 401(a)(9)

Congress wants tax-favored retirement plans to be *retirement* plans—not estate-building, wealth transfer vehicles. To promote its favored result, Congress enacted § 401(a)(9), which compels certain annual minimum distributions from plans beginning generally at age 70½ or (if earlier) at death. Failure to distribute the required minimum results in a 50% excise tax on amounts that should have been distributed but were not. § 4974.

In addition to telling us how much the participant must take out of the plan each year, the minimum distribution rules contain substantial material dealing with designating a beneficiary for retirement plan death benefits. If you want to take advantage of a beneficiary's life expectancy in calculating minimum distribution amounts, you must comply with these rules.

There are really two sets of "minimum distribution rules," dealing with two totally distinct situations: one set of rules applies when the plan participant (P) dies before his "required beginning date." See "Death Before the RBD: The Five Year Rule." The other set of rules deals with distributions required *during life*, *i.e.*, distribution of "retirement benefits," when P reaches his "required beginning date." See "The RBD: Required Lifetime Distributions."

From the estate planner's point of view, the minimum distribution rules generate two concerns. First, the planner must make sure that the participant or beneficiary complies with the minimum distribution rules by withdrawing each year at least the amount required by these rules, to avoid the 50% excise tax. Second, the designation of a beneficiary for death benefits needs to satisfy various rules if the client wants the option of postponing income taxation of the benefits for the longest possible time.

The proposed regulations

On July 27, 1987 the IRS issued proposed regulation § 1.401(a)(9)-1 & 2 and § 54.4974-2, interpreting and implementing the minimum distribution rules. These proposed regulations were amended in December 1997; see "Retirement Benefits Payable to Trusts." Most of the proposed regulations are addressed to qualified plans. Under the congressional mandate that "similar rules" shall apply to IRAs and 403(b) plans (§§ 408(a)(6), 403(b)(10)), the IRS has made the 401(a)(9) proposed regulations applicable to these other types of plans as well, with certain variations. See Prop. Reg. § 1.408-8, A-1 (IRAs) and § 1.403(b)-2 (403(b) plans). To date, final regulations have not been issued, so these proposed regulations are *the* source material for understanding the minimum distribution rules. *References in this chapter to "proposed regulations" refer to Prop. Reg. § 1.401(a)(9)-1 unless otherwise specified.*

Warning: while the following discussion of the minimum distribution rules applies to most qualified retirement plans and IRAs, there are grandfather rules and exceptions which exempt some individuals and plans from some or all of the requirements. See "The Minimum Distribution Rule Grandfathers" and "Pre-1987 403(b) Plan Balances," Chapter 10.

Legal status and effect of proposed regulations

Proposed regulations do not have the force of law. Proposed regulations have been described by one court as having no more standing than one party's brief in a case. In the absence of final regulations, a taxpayer is protected if his actions are permitted under "a reasonable interpretation of the statute," even if final regulations later do not allow such actions. On the other hand if the taxpayer complies with the Proposed Regulations, he is protected against later changes because the Proposed Regulations provide that: "taxpayers may rely on these proposed regulations for guidance pending the issuance of final regulations. If, and to the extent, future guidance is more restrictive than the guidance in these proposed regulations, the future guidance will be applied without retroactive effect." Prop. Reg., preamble.

The primary purpose of this chapter is to assist planners who are looking for a "safe harbor" for their clients' estate plans. Accordingly, most of this chapter is about how to comply with the IRS's pronouncements, especially the proposed regulations. However, until final regulations are issued, other ways of doing things must be considered acceptable if they constitute a "reasonable interpretation of the statute." Furthermore, if a particular interpretation of the law has been adopted by the IRS in several letter rulings, it presumably is safe to conclude that that interpretation is "reasonable." In some letter rulings the IRS says as much; see, *e.g.*, PLR 9311037 (12/22/92). When reading this chapter, particularly in "cleanup mode," bear in mind that the proposed regulations are not "the last word."

Death before the RBD: the Five Year Rule

One part of the minimum distribution rules tells us what distributions are required if a participant (P) dies before his "required beginning date" (RBD). § 401(a)(9)(C). Generally, the RBD is April 1 following the year in which the participant reaches age 70½, but see "The Required Beginning Date: When It Is," below, for exceptions. These rules are sometimes said to apply when death occurs "before age 70½." Strictly speaking, this should be "before the RBD."

Note: this set of distribution rules applies to a *Roth IRA* regardless of when the participant dies, because a Roth IRA "has no RBD." See Chapter 5.

The five year rule and its exceptions

Upon the death of a P before his RBD, the general rule is that all benefits must be distributed from the plan within five years after the date of death (the "five year rule"). § 401(a)(9)(B)(ii). Although the Code says "within five years after the death" of P, the proposed regulations are a little more liberal, requiring that the distribution must occur by "December 31 of the calendar year which contains the fifth anniversary" of the date of death. Prop. Reg. § C-2.

An exception to this rule permits payments to be made over the life expectancy of P's "designated beneficiary" (DB) if certain requirements are met. § 401(a)(9)(B)(iii). There are even more liberal exceptions to the five year rule if P's surviving spouse ("S") is the DB. § 401(a)(9)(B)(iv). Here is an overview of the five year rule and its exceptions:

If P dies before his RBD for a particular retirement plan, all benefits from that retirement plan must be distributed:

(a) by 12/31 of the year which contains the fifth anniversary of P's death;

OR

(b) if payable to S, in annual installments over S's life or life expectancy, beginning no later than 12/31 of the year after the year in which P died, or (if later) 12/31 of the year in which P would have reached age 70½, Prop. Reg. § C-3(b) (NOTE: the special distribution rules that apply when the surviving spouse is the beneficiary are discussed at "The Spouse and § 401(a)(9)," Chapter 3);

OR

(c) if payable to a "designated beneficiary" other than the spouse, in annual installments over the life or life expectancy of the DB beginning no later than 12/31 of the year after the year in which P died. Prop. Reg. § C-3(a).

Importance of having a "designated beneficiary"

The option to defer income taxes can be extremely valuable. The financial effect on the family of being forced to take out all benefits *within five years after P's death*, versus being permitted to take them out gradually *over the life expectancy of a beneficiary*, can be dramatic.

Example: Lena and Tina. Two brothers died. Each brother left his entire estate, including a $500,000 IRA, to his daughter. Both daughters, Lena and Tina, were 38 years old. Each of the daughters, after taking a round-the-world cruise, buying a new house, and paying the estate taxes on her father's estate, was left with just one asset, the $500,000 IRA. Each daughter decided to regard the inherited IRA as her own retirement nest egg, and resolved to: withdraw from the IRA only the minimum amount required by law; invest the after-tax proceeds of the withdrawal; and accumulate the earnings (after taxes) as her retirement fund.

Each daughter kept her resolve, investing both in-plan and out-of-plan assets in 8% bonds, and paying income taxes on all plan withdrawals and bond interest at the rate of 36%, but there was one difference: Tina's father had named Tina as his "designated beneficiary" (DB), so Tina was entitled to withdraw her father's IRA in installments over her 44.4 year life expectancy. Lena's father had named no beneficiary; he never got around to filling out a designation of beneficiary form. Under the terms of the account agreement governing his IRA, since he had not named any beneficiary, his "beneficiary" was his estate. In minimum distribution rule jargon, he "had no DB." Lena, the sole beneficiary of the estate, had to withdraw all money from her father's IRA within five years after his death.

After 30 years, Lena has a $1.5 million investment portfolio, all outside of any IRA. Tina has an investment portfolio of $1.4 million outside the IRA; and also has $1.5 million still *inside* the IRA she inherited from her father. Tina still has 14.4 years left in her "life expectancy" over which to withdraw the remaining IRA balance. After 30 years, the daughter who used the "installments over life expectancy" payout method has almost twice as much money as the daughter who withdrew benefits under the "five year rule."

Clearly, it is vital for the planner to understand how to go about naming a "DB." If the participant has a DB, then, on the participant's death, the DB will have the luxury of choosing to spread out the distributions from the plan over his life expectancy. (Remember, these distributions are just the *minimum* the beneficiary must take. The beneficiary can always take out more than the minimum—in fact the IRS would be delighted to have him do so.) But if there "is no DB," then the recipient who inherits the benefits will have no choice: benefits will have to come out of the plan, and be taxed, within five years after P's death.

DB is a term of art; it does not mean whatever beneficiary the participant happens to have named. A DB must be an individual or a group of individuals (Prop. Reg. § D-2A); but, if some tricky rules are complied with, the participant can name a trust as recipient of his death benefits and the *beneficiaries of the trust* will be treated as the DB (see "Retirement Benefits Payable to Trusts," below).

The DB might be a beneficiary designated by P on forms provided for that purpose by the plan; or the plan itself may dictate who is P's beneficiary. Assuming an individual (or group of individuals) has been designated (either by P or by the terms of the plan), that individual (or group) will be his DB. Prop. Reg. § D-1.

If the beneficiary is "my spouse," or "my children," or "my issue," or any other human being or group of human beings, everything is fine: the participant has a "DB," *i.e.,* an individual or group of individuals whose life expectancy(ies) can be used to measure minimum required distributions. If P's estate or a corporation is named as the beneficiary, or if a trust has been named but the technical requirements are not met, then for purposes of the minimum distribution rules, P is said to have "no DB" and therefore the benefits must be distributed within five years after his death.

Naming an individual as beneficiary

If one person (such as the participant's spouse or a child) is the DB, then, under the exception to the five year rule, the beneficiary can withdraw the benefits "in accordance with regulations" over a period of time that does not exceed his life expectancy. § 401(a)(9)(B)(iii).

The proposed regulations provide that, to use this method, you first determine the beneficiary's life expectancy based on the beneficiary's age at his birthday in the year following the year of P's death. Prop. Reg. § C-1(b), E-2(a). Life expectancy is determined using the "expected return multiples" in table V of Reg. § 1.72-9 (partially reproduced in IRS Publication 590, and Appendix A). Prop. Reg. § E-3 & 4. The table gives a fixed measuring period, a number of years, which is the maximum number of years over which benefits can come out. Then, each year, the benefits remaining in the plan are valued, and the beneficiary must withdraw at least a certain fractional portion of those benefits. The first year, the fraction will be [one] divided by [the beneficiary's life expectancy]. In the second year, it will be [one] divided by [the beneficiary's original life expectancy reduced by one year], and so on. Prop. Reg. § F-1.

For example, if the beneficiary has a life expectancy of 27 years as of his birthday in the first year after the date of P's death, he must withdraw 1/27th of the benefits in that year. In the second year, he must withdraw 1/26th and so forth. Each year, the benefits remaining in the plan are valued, and that year's new fraction is applied to the new plan value to determine that year's required *minimum* distribution. The beneficiary is, of course, free to withdraw more than the minimum in any year.

This fractional method of calculating minimum withdrawals tends to produce gradually increasing installments over the years, so long as the plan has a positive investment return. As long as the beneficiary's remaining life expectancy is greater than [100] divided by [the plan's annual growth rate], the plan balance will be growing faster than the beneficiary is withdrawing it. For example, if the plan is growing at 8% per year, and the beneficiary's life expectancy is 20 years, the required minimum distribution (1/20, or 5%) is less than the plan's earnings for the year (1/12.5, or 8%). Eventually the beneficiary's life expectancy is reduced to the point that he is withdrawing more than the year's investment return. If the plan is growing at 8% per year, this crossover point would be reached at 12.5 years before the end of the payout period. Even after this crossover point, however, the annual required minimum distributions tend to keep getting larger, even though the plan balance is now shrinking, because the fraction applied to them is greater.

Distributions must commence by year after death

If the DB is taking out the benefits in installments over his life expectancy, the Code says such distributions *must* begin "no later than one year after the date" of death, "or such later date" as the IRS may prescribe by regulations. The proposed regulations require that the installments "commence on or before December 31 of the calendar year immediately following the calendar year in which" P died. Prop. Reg. § C-3(a).

This feature of the installment method contrasts with the five year rule, under which there is no requirement that distributions be made annually, or that any money come out of the plan at all until the last day of the period. Prop. Reg. § C-2.

Naming the spouse as beneficiary

The minimum distribution rules provide special breaks when the surviving spouse is named as beneficiary of retirement benefits. See "The Spouse and § 401(a)(9)," Chapter 3.

Naming more than one beneficiary

According to the proposed regulations, if there are multiple beneficiaries then:

(a) All members of the group must be individuals in order for the exception to the five year rule to be available. If even $1 of the benefit is paid to a non-individual, the participant is deemed to have "no DB," and the five year rule applies. Prop. Reg. § E-5. The difficulties created by this rule when it is desired to name both charitable and individual beneficiaries are discussed at "*Pitfall: naming a charity as one of several beneficiaries,"* Chapter 7; and

(b) If there are multiple beneficiaries all of whom are individuals the payout period is computed using the life expectancy of the beneficiary with the shortest life expectancy, *i.e.*, the oldest member of the group. Prop. Reg. § E-5(A)(1).

The proposed regulations provide that each of the beneficiaries may use his or her own life expectancy for his or her share of the benefits, *if* the retirement plan is divided into "separate accounts." Prop. Reg. § H-2(b). Thus, if P has four children, he could have four separate accounts, one payable to each of the children, within the IRA or retirement plan, and each "account" would have its minimum distribution amount calculated separately each year based on the life expectancy of the individual who was the beneficiary of that portion. Similarly, if there are are separate accounts and some are payable to individuals and some to non-individuals (an estate or charity for example), the individuals can use the life expectancy method for their separate accounts; the individuals' accounts are not "tainted" by the fact that other accounts are payable to non-individuals.

A "separate account" is "a portion of an employee's benefit determined by an acceptable separate accounting including allocating investment gains and losses, and contributions and forfeitures, on a pro rata basis in a reasonable and consistent manner between such portion and any other benefits." Prop. Reg. § H-2A(a).

Under the proposed regulations, these “separate accounts” must be established “as of” the date of the participant’s death. Prop. Reg. § H-2(b). Many practitioners interpret “as of” the date of death to mean that a fractional division of the account that occurs *effective on* the date of death qualifies for “separate account” treatment, even if the accounts are not actually separated until after the date of death. The Code seems to support this conclusion, since the Code says a payout over the life expectancy of the beneficiary is available for “the portion” of the account that is payable to that beneficiary. §401(a)(9)(B)(iii). PLR 9809059 (12/4/97) supports this conclusion.

Naming an estate as beneficiary: death before the RBD

According to the proposed regulations, if benefits are payable to the participant’s “estate,” the participant has “no DB,” and the five year rule applies, even if all beneficiaries of the estate are individuals. Prop. Reg. § H-7.

The proposed minimum distribution regulations reject the embedded principle of the estate tax that an individual and that individual’s estate are one and the same. For example, under the estate and gift tax law:

1. Property that passes from a decedent to the decedent’s spouse, in which no person other than the spouse *and her estate* has any interest, qualifies for the estate tax marital deduction. § 2056(b)(1)(A). Leaving property to the surviving spouse’s estate is considered exactly the same as leaving it to the spouse for purposes of the marital deduction.

2. The beneficiary of a trust is not deemed to “own” the trust property for estate tax purposes unless he has the power to transfer the property to himself, his creditors, or *his estate* (or the creditors of his estate). If he can appoint the trust property to his estate, then the trust property is included in his estate for estate tax purposes, even if he is not entitled to any distributions from the trust during life. § 2041(b)(1). The trust beneficiary and his estate are regarded as one and the same.

The proposed minimum distribution regulations are income tax rules, not estate tax rules, and accordingly are not obliged to be consistent with the estate tax scheme, and they do not follow the estate tax approach in this regard. Under the proposed regulations, the *estate* of a person who is a trust beneficiary is treated as a totally different and separate beneficiary from the *person himself*. The proposed regulations permit “looking through” a trust, to treat the individual trust beneficiaries as the “designated beneficiaries,” but have no comparable provision for estates.

Editorial Comment

In this author’s opinion, the IRS’s position that the life expectancy method is not available if the “estate” is a beneficiary is incorrect.

The Code provides that any portion of the employee’s benefit payable “to (*or for the benefit of*)” a designated beneficiary “may be distributed over that beneficiary’s life expectancy. § 401(a)(9)(B)(iii) (emphasis added). Benefits paid to an estate are paid “for the benefit of” the estate’s beneficiaries, and if the beneficiaries of the estate are all individuals (or qualifying trusts) they should be recognized as "designated beneficiaries" and allowed to use the life expectancy method.

The IRS has ruled on countless occasions (see "*Rollover when S inherits benefits through an estate or trust,"* Chapter 3) that when benefits are distributed to a surviving spouse as beneficiary of an estate or trust, as a matter of right, such benefits are paid "to" the spouse for purposes of the rollover rules. If benefits paid to an estate are paid "to" the surviving spouse (when she is the sole estate beneficiary) for purposes of a rollover under § 402, they are also paid "to" the spouse—and any other estate beneficiaries—for purposes of § 401.

The fact that some assets of the participant's estate (including retirement benefits) are paid to creditors, tax collectors or lawyers should not matter; these recipients are not sharing in the benefits as "beneficiaries" but rather as creditors of the individual decedent. All payments of debts, expenses and taxes are made "for the benefit of" either the deceased participant or his beneficiaries (*i.e.*, the people who inherit his estate), and if the beneficiaries of the estate are all individuals, that should be enough to assure "designated beneficiary status." The distinctions in the proposed regulation between an estate and a trust, and between an estate and its beneficiaries, should be eliminated.

Cleanup strategies: death before the RBD

When the participant dies before his RBD, and you discover that the beneficiary designation is not ideal, there are several strategies for correcting the situation and avoiding the five year rule.

1. **Spousal rollover**. The IRS, in its rulings, has been liberal in permitting the spouse (S) to roll over benefits even when S was not named directly as DB, so long as S had the absolute right (as beneficiary of an estate or trust) to receive the benefits. See *"Rollover when S inherits benefits through an estate or trust,"* Chapter 3. By rolling over the benefits to her own IRA, S can comply with the "five year rule" but still defer income taxes on the benefits.

2. **Disclaimers**. If S is not directly or indirectly named as beneficiary, consider whether disclaimers can be used to shift the benefits over to S. See *"Salvaging spousal rollover,"* Chapter 8.

3. **IRS Ruling**. Perhaps you believe there is a "designated beneficiary" (DB) entitled to use the life expectancy (LE) method, but the proposed regulations indicate otherwise. For example, perhaps P's beneficiary designation form said "pay $10,000 of my benefits to the Red Cross and the balance to my child." You reasonably believe that, under Code § 401(a)(9), child is entitled to take his share of the benefits over his LE, but § E-5 of the proposed regulations indicates that, since one of the named beneficiaries is not an individual, there "is no DB" and the five year rule applies. Consider applying for a ruling. The IRS ruling staff have issued rulings which in some cases appear contrary to the regulations. See, *e.g.*, PLR 9037048 (6/20/90), in which the beneficiary of a testamentary trust was treated as a "DB" despite the fact that the trust was clearly not irrevocable on the RBD as was then required by the proposed regulations.

4. **Wait and see**. If the client does not want to seek a private letter ruling, use a "wait and see" approach. Begin distributions based on the assumption that there is a DB, and that the installments-over-life-expectancy method is available. This means making annual installment distributions, beginning within one year after the date of death, based on the LE of the person you believe is the DB. Once four years have elapsed, review the situation again. By then there may be final regulations, cases or other legal guidance providing a definitive answer one way or the other; or the client may have decided that it is worth seeking a ruling. If the question has been answered unfavorably to your client, or if it still is ambiguous and your client still does not want to get a ruling, you can comply with the five year rule and distribute all benefits by December 31 of the year which contains the fifth anniversary of P's death.

5. **Beg for mercy**. If all else fails, the 50% penalty tax can be waived by the IRS if the distribution shortfall is due to "reasonable error." § 4974(d).

The Required Beginning Date: When It Is

The preceding discussion dealt with the minimum distribution rules applicable when P dies before his RBD. Once the RBD is reached, a new set of rules comes into play; those rules are described in the next section. *This* section tells how to determine what the RBD is.

Definition of "required beginning date"

The participant's "required beginning date" may be different for different plans:

For Roth IRAs: There is NO "required beginning date." See Chapter 5.

For all other ("traditional") IRAs: The required beginning date is April 1 of the calendar year following the year in which the participant reaches age 70½. § 401(a)(9)(C)(ii)(II).

For 403(b) arrangements: Effective for 1997 and later years, the required beginning date is April 1 of the calendar year following the *later of* the year in which the participant reaches age 70½ or the year in which the participant retires. § 401(a)(9)(C)(i); see also special rules in "Pre-1987 403(b) Plan Balances," Chapter 10.

For 401(a) ("qualified") plans:
If the participant is a 5-percent owner, the required beginning date is April 1 of the calendar year following the year in which the participant reaches age 70½. § 401(a)(9)(C)(ii)(I).
If the participant is not a 5-percent owner, the required beginning date, effective in 1997 and later years, is April 1 of the calendar year following the *later of* the year in which the participant reaches age 70½ or the year in which the participant retires. § 401(a)(9)(C)(i). See also special rules in "Minimum Distribution Rule Grandfathers," Chapter 10, for employees born before 1917 and employees who filed "TEFRA 242(b) designations."

Prior to 1997, the RBD was April 1 of the calendar year following the year in which the participant reaches age 70½ for all types of plans and participants, except for the "grandfathered" individuals discussed in Chapter 10. TAPRA '97 changed the definition to read as above for 403(b) plans and 401(a) plans, for non-5% owners.

The ability to postpone the RBD until actual retirement is of no interest to workers who want to retire before age 70½; or to the business owner who owns more than 5% of his company and thus is not eligible. Thus, the most immediately apparent beneficiaries of the 1997 expansion of the definition of RBD are high-income executives and service professionals who work for large firms; and own either no interest or just a small interest—less than 5%—in the sponsoring employer; and want to keep working past age 70½.

Definition of 5% owner

The ability to postpone the RBD until actual retirement is not available for "an employee who is a 5-percent owner (as defined in section 416) with respect to the plan year ending in the calendar year in which the employee attains age 70½." § 401(a)(9)(C)(ii) (I). In determining ownership percentages under § 416, a modified version of the constructive ownership rules of § 318 applies. Under these very complicated rules, a participant could be deemed, for purposes of the 5% test, to own stock held by various family members, trusts, estates, partnerships or corporations; and stock options must be taken into account.

How little work is not "retirement"?

How many hours does the participant have to work, in what time frame, in order to be considered not "retired?" The author can find no definition of "retirement" in any IRS pronouncements issued under TAPRA '97 or under pre-1986 law (when, as under the new law, "retirement" mattered as a trigger for required distributions). There will undoubtedly be cose cases in which it is difficult to tell whether distributions are required to begin:

Example: Herbert "retires" as a 2% partner of the Olde Law Firm. He receives a distribution of his share of the firm's capital plus a gold watch. However, although he has given up his partnership position, he keeps working on a part time basis at his same desk, as a salaried employee. Has he "retired?" What if he works only a few hours per year? What if he takes a "leave of absence" for two or three years, before he officially "retires?"

One plan, different employers

Another problem that has surfaced with respect to the definition of "retirement" is whether a participant may be considered "retired" as to some assets in a plan but *not* retired as to some other assets in the very same plan.

Example: Elizabeth is working full time as a doctor at Tibias, Inc., and is a participant in the Tibias Profit Sharing Plan. Because she owns less than 5% of the sponsoring employer, her distributions from the profit sharing plan do not have to begin until after she retires. However, in addition to the contributions by her current employer, this plan holds funds that were transferred to this plan from the plan of her *prior* employer, Femurs Corp., when her prior employer's practice was acquired by her current employer. Is the plan required to begin distributions from Elizabeth's account representing funds from the prior employer when Elizabeth reaches age 70½, since she is no longer working for the prior company (which no longer exists)?

There is a whole spectrum of variations on this theme. The IRS could decide that *all* funds held in a current employer's plan that represent accumulated contributions from a prior employer must begin distributing at age 70½, even if the change of "employer" was purely a change in the form of entity (*e.g.*, incorporation of a partnership). This approach would appear to be contrary to the intent of the new law, which is presumably to allow workers additional time to accumulate funds for retirement. Alternatively, the IRS could decide that all funds that are properly held by the current employer's plan (even if transferred from another employer's plan, or "rolled over" from another plan through an IRA) are eligible for the postponed required beginning date. Finally, the IRS could decide that some prior-employer funds held by the current plan sponsor (*e.g.*, where the current employer is a successor to the prior employer through a merger, acquisition or change of ownership form) are eligible for the postponed distribution, while some other types of prior-employer funds so held (*e.g.*, funds which were rolled into the plan from the plan of an unrelated former employer of the participant) are not.

Pending an IRS pronouncement on this issue, plan sponsors will have to determine what to do when holding plan funds that represent contributions for the same worker from different employers. Because compliance with the minimum distribution rules is a plan qualification issue, plans may tend to be conservative in interpreting the new law, and insist on making distributions from any prior-employer funds held for the employee, even if the employee is still working past age 70½.

Can a person "retire" more than once?

Example: Carmen retires from the Royal Cigar Company at 72 and starts receiving minimum required distributions. She is in the Palm View Senior Condo Development ... and hates it. She is bored and the Royal Cigar Company needs her back because business is booming. So at age 73 she goes back to work. Can her minimum required distributions be suspended until she retires *again*? The statute reads as though there is only one "retirement" per employee.

Changing beneficiaries after 70½

Example: Rachel works for the Red Cross. When she turned 70½ in 1995, she forgot to name a designated beneficiary. Since on her original "required beginning date" (April 1, 1996) she had no designated beneficiary, she has been taking distributions over her own life expectancy only. But now she has named a beneficiary (her son), and she's still working. Normally, once the required beginning date is past, it's too late for a participant to name a "designated beneficiary" and change her minimum required distributions from single to joint life expectancy. But under the 1997 change in the law it appears Rachel gets a brand new RBD, which will be April 1 following the year she retires. This should mean that after her new RBD the benefits can indeed come out over the joint life expectancy of herself and her new designated beneficiary. In effect, employees who regret the way they set up the beneficiary designation on their original required beginning date get another bite of the apple under the new law—*if* they are still working.

The RBD: Required Lifetime Distributions

Once a participant reaches his RBD, § 401(a)(9) forces him to start taking money out of his retirement plans.

What happens at the RBD

Money must start coming out of the retirement plan no later than the "required beginning date" (RBD). Although the date may differ for different people and different plans, as discussed in the preceding section, for most people in most plans the RBD is April 1 following the year in which the participant reaches age 70½ and the following discussion is based on that RBD.

The *slowest* rate the benefits can come out is, installments over the participant's life expectancy; or the joint life expectancy of the participant and his spouse; or the joint life expectancy of the participant and some other designated beneficiary—who for this purpose will be deemed to be no more than 10 years younger than the participant, regardless of the beneficiary's actual age. See "Naming a Non-Spouse DB," below. A participant who has "no DB" as of his RBD must withdraw all plan benefits over only *one* life expectancy period—his own. At age 70½, the "life expectancy" under IRS tables is either 15.3 or 16 years (see "How to Compute Life Expectancy and Installments," below).

Naming a DB at age 70½ is similar to naming a DB for pre-RBD death benefits with several *extremely important* differences:

(a) The existence or non-existence of a DB on the RBD, and the identity of the DB if there is one, freeze the payout period *permanently*. The participant can later change his DB, but can never do so in a way that lengthens the maximum payout period beyond what was established at the RBD. (The only "exception" to this rule is that, if the participant names his spouse as beneficiary, either before, at, or after his RBD, and she survives him, a spousal rollover can start a new payout period after the participant's death. See "Spousal Rollovers," Chapter 3.)

(b) Trust beneficiaries can be used as the DB, *if* the trust rules are complied with. See "Retirement Benefits Payable to Trusts," below.

(c) The participant must make an irrevocable election whether or not to recalculate his (and his spouse's, if the spouse is the DB) life expectancy annually; see "Recalculating Life Expectancies: Participant and Spouse," below.

Traditionally, estate planners "planned" for only one event—death. Later, planners added disability planning to their repertoire. Now planners must add a third focus to their efforts: the RBD. When a participant names a beneficiary *prior* to the RBD, it is similar to writing a will—the participant can change his mind later and write a new will (or name another beneficiary). Estate planners are familiar with this mode and often do not realize that naming a beneficiary *on* the RBD has a quite different effect: the beneficiary designation on the RBD is not merely a will-like designation of who will receive the benefits after the participant's death (although it is that—and to that extent is changeable); it is *also* an election as to how the participant's minimum distributions will be calculated each year, and on this point it is irrevocable.

The RBD is the continental divide. Planning should begin early for this event. If a trust is to be named as beneficiary, EXTREME CARE must be taken to comply with the trust rules discussed later in this chapter.

The good news is that most people have a "DB" whether they know it or not. A "DB," for purposes of the rules, is simply "an individual who is entitled to a portion of an employee's benefit, contingent on the employee's death or another specified event." Prop. Reg. § D-2(a)(1). The DB can be named in the plan itself, or (if the plan permits) by the participant on a beneficiary designation form.

Under many employer-sponsored plans, if the participant does nothing, his spouse is automatically his DB. Under many IRA arrangements, if the participant has not designated a beneficiary all benefits are payable to the participant's estate, and thus he is deemed to have "no DB." A participant who "has no DB" on his RBD will be required to withdraw all his plan benefits over just his own life expectancy. § 401(a)(9)(A)(ii).

Naming the spouse as beneficiary

If the spouse is the DB, the participant can take his benefits out in installments over the joint life expectancy of the participant and the spouse—whatever it may be. Prop. Reg. § F-1; Prop. Reg. §§ 1.401(a)(9)-2, Q-7. If the spouses are close in age, this will probably not be the longest possible payout period; for example, the joint life expectancy of two individuals age 70 and 68 is only 21.5 years. However, naming S as DB offers other tax and estate planning advantages (see Chapter 3), and it is what most people want anyway.

Naming the spouse as DB will almost always lengthen the payout period somewhat, compared to using just the participant's own life expectancy ("LE"), even if the spouse is the same age—or even if the spouse is older. The LE of an individual age 70 is 16 years; but the LE of two individuals both of whom are age 70 is 20.6 years. Even if the spouse is age 80 (*i.e.* 10 years older than the participant) adding her extends the payout period to 17.6 years.

Naming a non-spouse individual as beneficiary

Naming a child or other younger generation beneficiary often produces the longest payout period, despite the limits imposed by the MDIB rule. See "Naming a Non-Spouse DB," below.

Estate as beneficiary at the RBD

The IRS's position that an "estate" cannot be a DB (even if all beneficiaries of the estate are individuals) while a trust can be (see *"Naming an estate as beneficiary: before the RBD,"* above), can produce apparently arbitrary results. For example, if the beneficiary of Sylvia's IRA is a trust for the life benefit of Mickey, and the trust meets various requirements discussed later in this chapter, Sylvia can withdraw from her IRA over the joint LE of herself and Mickey. But if the IRA is payable to her estate, of which the same trust is the sole beneficiary (or even of which Mickey himself is the sole beneficiary) there "is no DB" and the joint life expectancy method cannot be used. See, *e.g.*, PLR 9501044 (10/14/94).

There is a reason for this distinction, however. A plan administrator can read the names of individual beneficiaries and determine their birthdates. A plan administrator can even, with a little more effort, read a trust instrument and determine who are the beneficiaries and what are their life expectancies. But when benefits are payable to "my estate," and the still-living participant reaches age 70½, how can the plan administrator determine who is the participant's beneficiary for purposes of computing minimum distributions? Even if the participant says "here's a copy of my will," the plan administrator can't be sure the will won't be amended or revoked.

Election to use single or joint life expectancy

The wording of the Code suggests to some who read it that P must *elect*, on or before his RBD, to use either a joint or single life expectancy to determine his MRDs. § 401(a)(9)(A)(ii). It is not uncommon, in fact, for retirees to file a form with the plan or IRA administrator "electing" to take the benefits over a single life expectancy. However, unless the plan or IRA agreement itself actually required such an election and makes it irrevocable, P's "election" on this point has *nothing to do with* the determination of his MRDs.

As far as the Code is concerned, the MRDs are determined by whether or not P has a DB. If P has no DB then an "election" to use a joint life expectancy is irrelevant because P's minimum distributions will be based on his single life expectancy. Similarly, if P has a DB, "electing" to take benefits out over his own single life expectancy does not increase the MRDs: the MRDs are based on the joint LE of P and his DB, and if P chooses to calculate the distributions based solely on his own life expectancy he is simply taking larger distributions than he has to. He can revert to taking distributions based on the joint LE at any time (and his DB can take distributions over the balance of that LE after P's death).

Example: Brenda names her husband Amnon as the DB of her IRA. When Brenda reaches her RBD she files a form with the IRA administrator, directing that the account be distributed to her over her LE only. However, she does have a DB: husband Amnon. As far as the minimum distribution rules are concerned, her MRDs are based on the joint LE of Brenda and Amnon, and she is simply choosing to take out larger distributions (based solely on her own LE) than she has to. As far as the minimum distribution rules are concerned, she can switch any time to taking smaller distributions, based on the joint LE of herself and Amnon.

Recalculating Life Expectancies: Participant and Spouse

A major question facing the participant who names his spouse as DB is whether to exercise the option to "recalculate annually" the life expectancy of the participant, of the spouse, or of both. § 401(a)(9)(D).

How recalculation works

Absent "recalculation," the life expectancy period over which benefits may be paid out is established as a fixed number of years (or "term certain" or "period certain") on the RBD. Then each year the minimum distribution is calculated by multiplying the current account balance by a fraction: one divided by the remaining number of years in the term certain (see "How to Compute Life Expectancy and Installments," below). Prop. Reg. § F-1(d).

When life expectancy is being recalculated annually, on the other hand, you go back to the actuarial table each year, and determine an entirely new life expectancy based on the participant's (and/or spouse's) new age. Prop. Reg. § E-8. Under this method, life expectancy does not go down by one full year each year; it goes down by something less than a full year. For example, the life expectancy of a 70-year-old is 16 years, while the life expectancy of a 71-year-old is 15.3 years. Reg. § 1.72-9, table V. Thus, for a participant who is using only his own life expectancy to calculate minimum distributions, the second year's fraction will be 1/15.3 if he is redetermining his life expectancy annually, compared to 1/15 if he is using a "term certain." Redetermining life expectancy stretches out the distribution of benefits during the participant's lifetime.

The advantage of annual recalculation is that the participant or couple will never "outlive" the retirement benefits, if they take out only the MRD each year (and the benefits do not disappear due to poor investment results). The IRS tables provide a life expectancy of more than one year all the way up to age 110. The disadvantage is that, in the calendar year following the death of a person whose life expectancy is being recalculated annually, that life expectancy is reduced to zero. If the participant's spouse dies, and her life expectancy was being recalculated, for example, the participant's remaining benefits will have to be paid out to him over only his own life expectancy. If both spouses' life expectancies are being recalculated, and both spouses die prematurely, the children (or whoever is the next succeeding beneficiary) will not get the benefit of a longer payout period—all remaining benefits will have to be distributed within *one year* after the surviving spouse's death.

In contrast, if life expectancies are NOT recalculated, the death of the participant or spouse makes no difference to the payout. (See "What Happens After the RBD," below). The contingent beneficiaries, or the participant's estate, or whoever is next in line, simply continues to withdraw over the balance of the term certain.

Which method is best?

There is no simple or universally "right" answer to the question of whether it is desirable to recalculate annually. For a married couple whose principal goal is to enhance their own retirement security and maximize their tax deferred income from this plan, and whose health and genetic background indicate that they have an above-average life expectancy, recalculation of both life expectancies annually will *probably* provide the most extended payout term. But if one or both spouses die prematurely, "recalculate both" would result in acceleration of distributions on the first death and immediate distribution of the entire balance within a year after the second death.

If the couple appear to have below-average life expectancies, then recalculation annually would probably not be advisable, and use of their fixed joint life expectancy period, determined as of the RBD, will probably produce a longer payout period and more tax deferral. (If both spouses clearly have shortened life expectancies, consider naming a child or grandchild as DB instead of the spouse, to gain greater income tax deferral, if this would not jeopardize the surviving spouse's financial security; see "Naming a Non-Spouse DB," below.)

Under any method, if the participant dies first, the benefits can be paid to the spouse at that point and rolled over by her to her own IRA, where she can start the process all over again by naming a new DB and choosing a payout period based on the joint life expectancy of, say, herself and the children. See "Spousal Rollovers," Chapter 3.

A compromise position is to have the participant's life expectancy recalculated annually, but not the spouse's. Prop. Reg. § E-7 permits the participant to recalculate the life expectancy of either spouse, neither, or both. This hedges the bets. If the spouse dies first, then the participant will at least have assured that the minimum payout period over which the benefits can be distributed is the spouse's original life expectancy. Thus there is a guaranteed minimum payout period, and no sudden acceleration of benefits if both spouses die prematurely. The payout period may be even more extended if the participant lives beyond his life expectancy.

This "split" or "hybrid" method has three drawbacks. First, calculating the annual distribution is more complicated (see "How to Compute Installments," below), although software can easily solve that problem (see Appendix D). Second, it tends to produce slightly *larger* required distributions than either of the other two methods (recalculate both, recalculate neither) in the early years, due to the IRS's prescribed formula which requires some rounding upwards of the spouse's age. Third, on the participant's death, it creates greater time pressures for the spouse to complete an immediate rollover, due to the acceleration of minimum distributions that occurs in the year following P's death. See "Spousal Rollovers," Chapter 3.

Another "hedging the bets" approach is for the participant to have several plans (*e.g.*, divide one big IRA into three smaller IRAs) and elect a different method for each. See IRS Notice 88-38, discussed under "Taking Distributions from Multiple IRAs," below.

Mechanics of making this election

The recalculation issue is benign if the spouses are aware of it and make a knowledgeable election. Unfortunately, that does not always happen. The proposed regulations permit a plan to allow participants to elect one way or another but also permit plans to allow no choice—and some plans and IRA account agreements require annual recalculation for both spouses. Furthermore, the proposed regulations say that if the plan (or IRA account agreement) is silent on this subject recalculation is mandatory! Prop. Reg. § E-7.

The election to recalculate or not must be made *irrevocably* as of the date of the first required distribution (Prop. Reg. § E-7(c)). This seems harsh since the election has no effect on the amount of the distribution until the second required distribution.

Normally, the election is made on the plan or IRA sponsor's account agreement or beneficiary designation form. Strangely, however, despite the importance of this election, some plans and IRAs do not have any particular form for making the election (and the IRS does not have any form on which participants can tell the IRS what election they have made). If the plan or IRA sponsor's forms do not cover this question, notify the administrator by (for example) a letter attached to the beneficiary designation form. See form 6.1 in Appendix B. Be sure to get an acknowledgment of receipt from the administrator, and to save the receipted copy "forever"; it will be needed, potentially, for several decades as evidence that minimum distributions are being calculated correctly.

Naming a Non-Spouse DB: The Incidental Benefit (MDIB) Rule

When a participant names someone other than his spouse as his DB, a special rule comes into play when determining the "joint life expectancy" of the participant and DB. The so-called "Minimum Distribution Incidental Benefit" (MDIB) Rule is designed to prevent a participant from unduly postponing distribution of his retirement benefits. This rule is not contained in the Code, though it is cryptically referred to in § 401(a)(9)(G), § 408(a)(6) and elsewhere. For details, see Prop. Reg. § 1.401(a)(9)-2, which this section summarizes.

Application during participant's life

Under the MDIB rule, P's minimum required distribution ("MRD") for each year is, as usual, determined by applying a fraction or "divisor" to the prior year end value of the account. However, when the MDIB rule applies, the fraction the participant is required to use is whichever of the following produces a *larger* MRD: the actual joint life expectancy of P and the DB; or the divisor specified in the "MDIB rule table."

For example, suppose P is age 71 in his "first distribution calendar year" and his non-spouse DB is age 47. The fraction determined using their actual initial joint LE is 1/36.5, but the fraction under the MDIB table is 1/25.3. The larger fraction, 1/25.3, must be used to determine the MRD for the first year.

The "MDIB rule table" is contained in the proposed regulations at § 1.401(a)(9)-2; and in IRS publication 590; and in Appendix A of this book. [**Editor's note: The table appears at the end of this document.]** The MDIB rule table contains divisors based, in each year, on the joint LE of P and someone 10 years younger than P. *E.g.*, in the year P is 70, the MDIB rule divisor is 26.2, which is the joint LE of two people ages 70 and 60. When P is age 81, the MDIB rule divisor is 16.8, which happens to be the joint LE of two people ages 81 and 71. The effect of the MDIB rule, approximately, is to "deem" the DB to be only 10 years younger than P every year. If the DB is less than 10 years younger than P, the MDIB rule has no effect because the real joint LE will always produce a larger fraction (smaller divisor) than the MDIB table.

Obviously, the MDIB rule forces distributions out of the plan at a faster rate than would occur with use of the actual joint life expectancy of P and his DB. However, it still provides a means to stretch out payments substantially during P's lifetime. In effect it gives the advantages of recalculating life expectancies (P never "outlives" benefits) without the drawbacks (because there is no acceleration of payments at P's death).

The "flip" at participant's death

Furthermore, if P dies before all his benefits have been paid out, the MRD calculations after his death will be based on the *actual* original joint life expectancy period of P and DB. The MDIB rule simply does not apply to distributions after the date of death. Prop. Reg. § 1.401(a)(9)-2, Q-3.

Thus, if P dies before all benefits have been paid out, the beneficiary can get an extremely long payout period for what remains in the plan at P's death.

This "flip" which occurs at P's death, from MRDs based on the MDIB table to MRDs based on the real joint LE of P and the DB, is extremely confusing because it is an exception to the normal rule that, once a participant dies, payments must continue to come out to the beneficiary "at least as rapidly" as they were coming out before P died (see "*Effect of P's death after RBD*," below). Under the MDIB rule, and the "flip" that occurs at P's death, payments dramatically slow down upon P's death.

Whether to recalculate life expectancy: when a non-spouse is the DB

The Code does not permit annual recalculation of life expectancy for anyone other than the participant and the participant's spouse. Therefore, the only election that needs to be made when a non-spouse is the DB is whether to recalculate the participant's life expectancy. The non-spouse DB's life expectancy is fixed on the RBD and cannot be recalculated.

Should P's LE be recalculated when there is a non-spouse DB? There is no simple "one-size-fits-all" answer to this question. Remember, what happens each year with a non-spouse DB while P is living is that you must determine *two* possible MRDs: the MRD based on the *actual* joint LE of P and DB, and the MRD based on the "MDIB divisor table." If the actual joint LE (such as "46 years") is a larger number than the MDIB divisor table number (such as "25.3") then you must use the smaller number (25.3) because that produces a larger MRD. Once P dies, you use the remaining *actual* LE, and no longer need to bother with comparing the actual LE number with the MDIB table number.

If you elect to recalculate P's LE, then, when P dies, his LE will go to zero, meaning you are left with only the remaining LE of the DB to measure payouts. If P's LE was not recalculated, on the other hand, his LE would not "disappear" at his death, so the remaining *joint* LE of *both* P and DB would be available to measure payouts after P's death. Since the joint LE of P and DB would necessarily be longer than the single LE of DB, using the fixed term method will produce a longer payout period (smaller MRDs) *after P dies*.

Does this mean a P who names a non-spouse DB should always elect the "fixed term" method? Not necessarily, because while P is still *living*, using the "recalculate" method may produce smaller MRDs, if the DB is not very much younger than P and P lives a long time. For example, suppose P is 70 and DB is 57. In the first year of the payout, their true joint LE (28.4) is ignored because the MDIB rule divisor (26.2) produces a larger distribution. However, when P gets older, the MRD could be quite different depending on which method P elected:

		Divisor when P is:		
		Age 80	**Age 85**	**Age 90**
1.	MDIB rule	17.6	13.8	10.5
2.	Actual remaining joint LE, fixed term method	18.4	13.4	8.4
3.	Actual joint LE, recalculated method	19.5	15.6	12.1

In this example, once P reaches his mid-80's, if he elected the fixed term method, the "actual joint LE" starts producing larger MRDs than the MDIB rule. That would never happen during P's lifetime if he had elected to recalculate.

Conclusion: although the differences are not dramatic, here are some guidelines on this decision:

1. If the DB is *substantially* younger than P (*e.g.*, a child or grandchild) it will probably make *no difference*, as long as P is living, whether P's LE is being recalculated or not. This is because the MDIB rule will always "override" the actual joint LE, that is to say, the MDIB rule will always produce a larger MRD. After P's death, the fixed term method will produce *slightly* smaller MRDs than the recalculation method. Therefore, if the DB is much younger than P, P should probably elect "fixed term" because that will produce slightly better results after P's death and will make no difference during P's life.

2. If the DB is not much more than 10 years younger than P (*e.g.*, DB is in his late 50's), then the question is more difficult. Which method is "better" depends on when P dies. If P dies before the end of the original joint LE of P and the DB, the DB will be better off if the "term certain" method was used—because the DB can withdraw over the balance of that joint LE and will not be forced to withdraw over only his or her own LE. But if P lives a long time, recalculation produces a better result, because smaller MRDs will be required during P's later life.

What Happens After the RBD

Effect of P's death after the RBD

When P dies after his RBD, the Code simply says that distributions must continue to be made "as least as rapidly" as prior to P's death. § 401(a)(9)(B)(2). ERISA practitioners confidently refer to this as "the atleastasrapidly rule," as if simply uttering this phrase answered any possible questions. Actually, the meaning of this rule is far from self evident and payments in some cases do *not* have to be made "as least as rapidly" as prior to P's death. What happens to the required distributions after P's death depends on: who was P's DB at the RBD; what elections P made at his

RBD regarding method of determining life expectancy; and whether P changed his DB after his RBD (and if so who he named as his new DB). For a quick overview, see the chart inside the back cover of this book.

A more precise statement of the rule is: distributions must continue to be made, to the beneficiary, over the remaining period of the single or joint life expectancy payout period that P was using to measure his MRDs immediately prior to death, subject to the following variations and wrinkles (with cross reference to the place in this book where the details are fully explained):

1. The MDIB rule ceases to apply; see "*Participant and non-spouse DB: the MDIB rule*," below.

2. If P changed his beneficiary after his RBD, see the next two subsections.

3. If P's life expectancy was being redetermined annually, it goes to zero in the year following his death.

4. If P's beneficiary is his surviving spouse, see "Spousal Rollovers," Chapter 3.

5. For the effect of a disclaimer, see Chapter 8.

6. For exact details on how to compute the post-death MRDs in various situations, see "How to Compute Life Expectancy and Installments," below.

Changing DBs after the RBD

This subsection deals with P's *naming* a new beneficiary after the RBD, not the death of the original DB. For what happens if the DB *dies* after P's RBD, see "Checklist of Minimum Distribution Results" ("Permutations") in Appendix C.

The participant can change his DB after his RBD. There are limits to what can be done, but there is more flexibility than many people realize.

The limitations are: if the participant "had no DB" on his RBD, nothing he does later will change that fact. The participant can change the identity of the beneficiary who will receive the benefits after his death, but he cannot, after the RBD, create a DB for purposes of calculating a joint life expectancy payout period if there was no DB on the RBD. (The only "escape hatch" in this situation is this: if P "had no DB" on his RBD, but later names his spouse as beneficiary, and the spouse survives him, the spouse can then roll the benefits to a new IRA in her own name and properly name a DB for it. See Chapter 3.)

The other primary limitation is similar: you cannot, by changing to a *younger* DB after the RBD, lengthen the maximum payout period, but changing to an *older* DB will shorten it. Basically there are three rules if the beneficiary is changed *after* the RBD:

(a) If the "change" occurred because a beneficiary died, it is disregarded. The death of a beneficiary after the RBD is NOT treated as a "change" of beneficiaries. Prop. Reg. § E-5(e)(2).

(b) If the new beneficiary has a longer life expectancy than the original "DB," the change has no effect on the minimum distributions. The payout continues to be measured by the joint LE of P and the original DB.

(c) If the new beneficiary has a *shorter* LE than the original DB; or if P changes, after his RBD, from "having a DB" to "having no DB" (for example, by changing his beneficiary designation from "pay all to my child X" to "pay all to my estate"); then subsequent payouts will be measured by the new shorter joint LE of P and the new DB (or by P's LE only, if the change is from "having a DB" to "having no DB").

Example 1: Changing to an older DB. If the original DB (as of the RBD) is P's brother (eight years younger than P) P can change and name his sister (six years younger than P) as his new DB. This will shorten the "joint LE" for purposes of calculating subsequent minimum distributions because the new DB has a shorter life expectancy than the original DB.

Example 2: Changing to a younger DB. If the DB on the RBD is P's six-years-younger sister, P can change and name his eight-years-younger brother as his new DB. However, because the RBD has already passed, this will not lengthen the maximum payout period, which will continue to be measured by the joint LE of P and the original DB, his sister.

Example 3: Changing away from the MDIB rule. If the DB is P's child, P can change the DB to P's spouse (S). The new maximum payout period will be, the joint life expectancy of P and S, or the joint life expectancy of P and the prior DB, whichever is shorter.

If the payouts prior to the change of DB were being measured under the MDIB rule limitation, does this artificially shortened "joint LE" continue if S is named as the new DB? Possibly not. If "a new designated beneficiary with a life expectancy shorter than the life expectancy of the designated beneficiary whose life expectancy is being used to determine the distributions period...replaces a designated beneficiary, the new designated beneficiary is treated as the designated beneficiary for purposes of determining the distribution period." Prop. Reg. § E-5(c)(1). Thus, a P who named a child as his DB, and is taking distributions over the joint life expectancy of himself and the child as limited by the MDIB rule, can reduce the distributions payable during his life, even after his RBD, by marrying someone who is more than 10 years younger than he but older than the child and naming her as his new DB. (Or, if he is already married to someone more than 10 years younger than he but older than his child, by naming his spouse as his DB instead of his child.)

Example 4: Changing from an individual to a trust. P can change his DB from any individual to a trust of which that individual or other individuals are the beneficiaries. See "Retirement Benefits Payable to Trusts," below, for additional requirements which must be met if a trust is named as beneficiary. Of course, if the LE of the oldest trust beneficiary is shorter than the LE of the original DB, the change will shorten P's payout period.

A change of DB affects the size of distributions beginning with the year *after* the year of the change. Prop. Reg. § E-5(c)(3).

A stumper: on his RBD, Grandpa names Lolita, his 25-year-old "significant other," as his DB. Payouts begin to Grandpa based on the joint LE of himself and Lolita, as limited by the MDIB rule. At age 73, Grandpa marries Lolita. Does the MDIB rule go away now that the DB has become the spouse? The answer to this is not clear.

The proposed regulations are very clear on what happens if (i) S is the DB on the RBD and (ii) S ceases to be the spouse due to divorce or death. In that case, the MDIB rule does *not* kick in. A change of status from "spouse" (on the RBD) to "no longer spouse" (sometime after the RBD) has no effect, and P can continue to withdraw over the joint LE of P and S. Prop. Reg. § 1.401(a)(9)-2, Q-7(d). The regulations are silent on a change of status in the other direction—from non-spouse on the RBD to, later, spouse.

The biggest problem with changing the DB after the RBD is often the fact that you cannot change the election regarding recalculation of life expectancy. For more discussion of the issues and solutions, see the *Fallon* and *Murphy* case studies.

Changing DBs after age 70½ but before the RBD

A final emphasis: the key date is the RBD (see "The Required Beginning Date: When It Is," above). The wise participant begins planning early for this event, and may file a beneficiary designation and elections regarding the form of benefits well before his RBD. As far as the minimum distribution rules are concerned, these are completely amendable and changeable at any time prior to the RBD. This may work favorably or unfavorably. Also, the *plan* may limit the options for later change even when the *tax law* does not.

Example 5: On June 1 of the year he turned 70½, Charlie filed an election form naming his estate as beneficiary of his IRA, and by December 31 withdraws the first year's installment based on his LE only. The next year, BEFORE APRIL 1, he changes his mind and names his grandson Arthur as his beneficiary. Because he changed his beneficiary designation before April 1 (his RBD), he can use the joint LE of himself and Arthur (as limited by the MDIB rule) to measure his subsequent MRDs.

Example 6: In 19998, the year she turns 70½, Louise names her grandson Waldo as beneficiary of her IRA, and her husband Ralph as her contingent beneficiary. Unfortunately, in March 1999, Waldo dies in an accident, just before Louise's RBD. Because he died before Louise's RBD, he was not her DB "on" her RBD. Ralph, the former contingent beneficiary, becomes the DB "on" the RBD and Louise must measure MRDs using the joint LE of herself and Ralph, not herself and Waldo for 1999 and later years. For her first MRD, however (the one for the age 70½ year, which must be distributed by 4/1/99), she can use the joint LE of herself and Waldo (as limited by the MDIB rule) because he was her DB *at some point* in the first three months of 1999 (see "*The limbo period*," below).

Example 7: Roger retires at age 68 and elects to take his pension benefits in the form of a joint and survivor annuity with his wife Imelda. Later, he decides that an installment payout over the joint LE of Roger and his daughter Emily would be more advantageous. Unfortunately his employer's pension plan does not allow him to change his election even though the minimum distribution rules would. There is nothing he can do about this. Within certain limits, plans are allowed to be more restrictive than the Code.

Taking Distributions from Multiple IRAs

IRS Notice 88-38

If the client participates in more than one "qualified" retirement plan, the MRD must be calculated separately for each plan, and each plan must distribute the MRD calculated for that plan. Thus if the client is a participant in two pension plans and a 401(k) plan, he will receive three separate MRDs, one from each of these plans.

A different rule applies for IRAs. The MRD must be calculated separately for each IRA, but the participant does not have to take each IRA's calculated amount from that IRA. He can total up the MRDs required from all of the IRAs, and then take the total amount all from one of the IRAs, or from any combination of them. Notice 88-38, 1988-1 C.B. 524.

This special rule also applies to 403(b) plans. The MRD must be calculated separately for each 403(b) arrangement, but the participant does not have to take each 403(b) account's calculated amount from that 403(b) account. He can total up the MRDs required from all of his 403(b) arrangements, and then take the total amount all from one of them, or from any combination of them. Notice 88-38, 1988-1 C.B. 524.

Since each IRA (or 403(b) plan) may have a different "designated beneficiary," or different method of computing the participant's (or spouse's) life expectancy, the Notice offers great planning flexibility.

Example 1: Anthony establishes two equal IRAs at his RBD, naming his wife Bernice as DB of one and their son Stacey as DB of the other. Because Bernice and Stacey are different ages, the annual MRD for each IRA will be different. Assuming Anthony wants to keep the bequests to his wife and son equal, Anthony can (1) determine the MRD separately for each IRA, (2) determine the total MRD for the year (the sum of the MRDs from each IRA) and (3) take half of the total MRD from each IRA.

Example 2: At her RBD, Marcia established three equal IRAs, naming one of her three children as DB of each. Investment results differ in the three accounts, causing them to become unequal in value. Because Marcia wants each child to receive an equal amount, she decides to take the year's MRD from only the larger account(s).

Example 3: Jo Claire established two IRAs at her RBD. Her spouse is DB of both, but on one account she elected to recalculate both spouses' life expectancies annually, and on the other she elected the fixed term method. Now she regrets the election to recalculate and wishes she had elected only the fixed term method. By taking the MRD for both IRAs only from the "recalculate" IRA, she can gradually deplete that one and allow the "fixed term" IRA to grow.

Example 4: Burton, age 72, is the beneficiary of his late mother's IRA. In addition, he has an IRA of his own. Both generate MRDs each year. He can take the total MRD for each year from either account.

Example 5: Jeffrey dies, leaving two IRAs. One is payable to a marital deduction trust, the other to a credit shelter trust. The "trust rules" are complied with, so the beneficiaries of the respective trusts are treated as Jeffrey's DB, and the life expectancy of the oldest is used to measure the post-death MRDs. Assume the credit shelter trust permits accumulation of income. If the family's goal is to maximize income tax deferral and minimize estate taxes, then perhaps, although Notice 88-38 does not specifically mention this situation, each year's MRD could be taken entirely from the IRA payable to the marital trust. The credit shelter trust would get the maximum available income tax deferral and what income taxes had to be paid would be paid by the marital trust, where at least they could reduce the spouse's future taxable estate.

Notice 88-38 applies only to IRAs and 403(b) plans. MRDs from qualified plans cannot be combined with each other or with IRAs or 403(b) plans, and IRAs cannot be combined with 403(b) plans. If a client is a participant in a 401(k) plan, a pension plan, two 403(b) plans, and three IRAs, he must calculate the MRD separately for *each* of his seven plans; then he must take the 401(k) plan MRD from the 401(k) plan; the pension plan MRD from the pension plan; the 403(b) MRDs from either or both of the 403(b) plans; and the IRA MRDs from any one or any combination of the IRAs.

Transferring assets between IRAs after the RBD

It is *not* possible to modify MRD results by moving assets from one IRA to another! Not only does transferring assets between IRAs after the RBD not improve the MRD status, it creates a major accounting headache: If assets in one IRA are moved to another IRA with a younger designated beneficiary (or a different method of determining life expectancy), the proposed regulations require the "new" and "old" assets in the transferee IRA to be accounted for separately, and the MRD to be computed separately for each "pool." Prop. Reg. § G-2(b).

PART VI: MINIMUM DISTRIBUTIONS UNDER 2001 PROPOSED REGULATIONS

This PART VI explains the minimum distribution rules that then existed under the IRS's 2001 proposed minimum distribution regulations. It is excerpted from a 2001 seminar outline.

New
Understanding the ^ Minimum Distribution Rules

The January 2001 Amendments to the Proposed Regulations

Introduction: New Proposed Regulations

IRS issues new proposed minimum distribution regulations

The IRS decided not to wait for Congress to enact the Pension Reform Bill, one mandate of which was that the IRS "simplify" the minimum distribution rules. On January 11, 2001, the IRS issued new proposed minimum distribution regulations. The new proposed regulations make major changes to the existing scheme (which has been in effect since the 1987 proposed regulations were issued).

The three main changes made by the new rules are:

1. The new proposed regulations provide a simple, uniform method for calculating lifetime required distributions. From now on, almost all individuals will use one table (called in this outline the "Uniform Table") for calculating lifetime required distributions, regardless of whom they have named as beneficiary and without the need to elect a method of determining life expectancy. The Uniform Table appears at the end of this outline. See "The New Way to Determine Lifetime Distributions," below.

2. For post-death required distributions, the "Applicable Distribution Period" will be the life expectancy of the designated beneficiary who actually inherits the benefits when the participant dies (not, as previously, the beneficiary who was named as such as of the "date of death or required beginning date, whichever occurred first"). See "The New Way to Determine Post-Death Distributions," below; and

3. The identity of the post-death designated beneficiary is not finalized until the end of the year after the year of the participant's death, allowing some "cleanup" to be done via post-mortem planning (disclaimers, divisions and distributions). See "Identity of DB Determined at End of Year after Death," below.

The new rules substantially simplify estate planning and minimum distribution planning at and after age 70½. The *gotcha!* quality of the old regime is gone. The generous income tax deferral formerly available only to a select few participants who managed to qualify for the "MDIB rule" is now available to all employees and IRA owners. Beneficiaries can be changed after the required beginning date and even after death.

The debate about "which is the best method of determining life expectancy" (fixed term, joint recalculation or split method) disappears. Under the new rules, all participants and spouses automatically get the benefit of recalculation (distributions stretch over the entire lifetime), but without the drawbacks (because post-death distributions to non-spouse beneficiaries convert automatically to the fixed-term method). Since the IRS gives everyone the best of both worlds, there is no need to elect anything, and the election has simply been abolished.

The significance of the RBD in estate planning is almost totally eliminated. Under the new rules, only two things happen at the RBD. The first is that the participant must begin withdrawing from his account by that date; the second is that the post-death distribution rules are slightly different if the participant dies after the RBD rather than before (but the difference has no planning implications that I can think of). In other words, the required beginning date is now just that—the date distributions are required to commence. It is no longer the date when a participant must irrevocably choose a beneficiary or a method of determining life expectancy.

Once the new rules are fully implemented, most of the minutiae of how to compute required distributions will now be of concern only to plan administrators and IRA providers; estate planners will no longer have as much of a stake. Estate planners from now on can focus on the (still very significant) pure estate planning questions involved in planning for retirement benefits; see "What's Unchanged; New Problems; New Opportunities," below.

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Where to find the law; effective dates

The new proposed regulations are numbered 1.401(a)(9)-0 through 1.401(a)(9)-8; 1.403(b)-2; 1.408-8; and 54.4974-2. The proposed regulations begin with a "Preamble." At the website www.ataxplan.com there are hyperlinks to the Leimberg Services, MRD-Determinator Software and Brentmark Software websites where (as of this writing) the proposed regulations are reproduced in full.

The new proposed regulations completely restate and replace the 1987 proposed regulations; however, both sets will be effective in varying degrees at least through 2001. The IRS proposes that these regulations will become final for calendar years beginning on or after January 1, 2002. MRDs for the distribution year 2001 "may" be calculated using either the new proposed regs or the 1987 proposed regs; however, there is a significant difference in the optional effective date depending on the type of plan. For details, see "Comments by Type of Plan," below. Also, an individual whose required beginning date is April 2, 2001, cannot use the new rules for his year-

2000 MRD, even if part or all of that MRD is being taken in the year 2001. His year-2000 MRD must still be determined under the old rules. IRS Notice 1270.

So, 2001 will be a transition year, in which both sets of regulations are in effect (to the extent proposed regulations can be said to be in effect). The transition period may well last beyond 2001, if the IRS extends the proposed effective date for final regulations to give IRA providers and plan administrators time to switch over to the new system. I recommend the commentary of Noel Ice, available to subscribers to the Leimberg Services Employee Benefits e-Newsletter (www.leimbergservices.com) regarding the legal status of proposed regulations and "repealed" proposed regulations.

To the extent "future guidance is more restrictive than the guidance in these proposed regulations, the future guidance will be issued without retroactive effect." P.R., Preamble, "Proposed Effective Date."

Terminology used in this outline; limitations of this outline

Citations to section numbers ("§") refer to sections of the Internal Revenue Code of 1986, unless preceded by "P.R.," in which case they refer to sections of the new proposed minimum distribution regulations issued 1/11/01. "Old P.R."refers to the 1987 version of the proposed regulations.

References to *Life and Death Planning for Retirement Benefits* refer to the author's book of that name (3d edition, 1999, Ataxplan Publications; 1-800-247-6553; $89.95 plus shipping).

Cross references to other parts of this outline give the heading of the section (initial-caps) or subsection (italicized); look up that heading in the Table of Contents to find the page number.

Under the new proposed regulations, the term "employee" includes an "IRA owner." In this outline, "participant" means the employee for whom a retirement benefit is established or an individual who establishes an IRA for himself (or for whom an IRA is established by his spouse).

Gender convention: since much of this outline deals with rules applicable to "the participant" and "the participant's spouse," I have tried to make it easier to follow by always referring to the participant as "he" and the spouse as "she," rather than using the awkward "he or she" (as in "he or she can name his or her spouse, and the spouse can then roll over his or her share of the benefits"), or the grammatically correct but startling "he" (as in "the participant can leave the benefits to his spouse, who can then roll them over to his own IRA") for both spouses. Needless to say, all statements apply equally to a female participant and her male spouse.

"Designation Date" means December 31 of the year after the year in which a participant dies. See "Identity of DB Determined at End of Year after Death," below.

"MRD" stands for minimum required distributions (under § 401(a)(9) and the proposed regulations).

"RBD" stands for "required beginning date" as defined in § 401(a)(9)(C).

The rules discussed in this outline are only those that deal with non-annuity payouts from individual account (defined contribution) plans. While the proposed regulations also cover the subject of annuity payouts from defined benefit plans, this outline does not cover that subject.

The New Way to Determine Lifetime Distributions

(Almost) everyone uses same table to determine lifetime MRDs

The first significant change made by the new rules is in how minimum distributions from an individual account plan (defined contribution plan) are determined once a participant reaches his required beginning date (RBD).

As always, minimum required distributions are determined by dividing the participant's account balance (revalued annually) by a life expectancy factor (called the "divisor"). Under the old rules, the "divisor" used by any particular participant varied depending on who was his designated beneficiary on the required beginning date, what method he had elected to use to determine his life expectancy of himself and (if applicable) that of his spouse, and whether the participant had changed his choice of designated beneficiary after the RBD. There were four possible computation methods just for a participant whose beneficiary was his spouse (both life expectancies redetermined annually; neither life expectancy redetermined annually; participant's life expectancy redetermined annually and spouse's not; spouse's life expectancy redetermined annually and participant's not), plus three possible methods to be used for non-spouse beneficiaries (neither life expectancy redetermined annually; participant's life expectancy redetermined annually and beneficiary's not; MDIB Rule table), and two possible methods to be used if the participant had no designated beneficiary (participant's single life expectancy recalculated; single life expectancy not recalculated).

The new proposed regulations replace these nine possible ways of determining the "divisor" with just two: one which applies to any participant whose sole beneficiary is his spouse who is more than 10 years younger than he is (see "*Lifetime distributions if DB is much younger spouse*," below); and the other, called in this outline the "Uniform Table," to be used by everyone else. P.R. § 1.401(a)(9)-2, A-1(c); -5, A-4.

The new Uniform Table is our old friend the "MDIB rule table." The divisors in the old MDIB Rule/new Uniform Table represent the joint life expectancy of a participant age 70 (or older) and a hypothetical beneficiary who is ten years younger than the participant. Thus, the initial divisor under this table (for a participant age 70) is 26 years (the joint life expectancy of someone age 70 and someone age 60).

The IRS fudges the Code's requirement (that benefits must be distributed over the joint and survivor life expectancy of the participant and his designated beneficiary) by saying that the new table "reflects the fact that an employee's beneficiary is subject to change until the death of the employee and *ultimately may be* a beneficiary more than 10 years younger than the employee"! P.R., Preamble, "The uniform distribution period"; emphasis added.

The Uniform Table is reproduced at the end of this outline. To calculate lifetime MRDs under this table, first determine the participant's age on his birthday in the applicable distribution year. Then divide the prior year-end account balance by the divisor in the Uniform Table that corresponds to that age. That's it! It's hard to get much simpler than that.

Example: Kenny turns age 73 on his birthday in the year 2001. The applicable divisor for age 73 is 23.5. On December 31, 2000, the value of his IRA was $750,000. Divide $750,000 by 23.5; the result ($31,915) is Kenny's minimum required distribution for 2001 for that IRA. This is the

2001 required distribution for Kenny's IRA *regardless* of who is his designated beneficiary (with one limited exception; see "*Lifetime distributions if DB is much younger spouse*," below), *regardless* of whether he even had a designated beneficiary on his required beginning date, *regardless* of whether he changed his beneficiary after the required beginning date, and *without regard to* any election of a method of determining life expectancy.

Contrast with old rules; good news for charities and aged spouses

Under the old rules, the 26-year divisor at age 70 was available only to participants who managed to name a younger generation beneficiary on or before their required beginning dates. Most 70-year-old participants named their close-in-age spouses as their beneficiaries (or named no designated beneficiary) and had to use a smaller divisor (e.g., 19.6 years for a 70-year-old participant and same-age spouse). The smaller divisor dictated by the old rules resulted in larger required distributions, less income tax deferral and ultimately less money for the participant's old age (or for his heirs). Under the generous and simple new rule, all participants get to use the "MDIB rule," and profit from the longer tax deferral formerly available only to a few.

Deeming everyone to have a young designated beneficiary is not the only benefit of the Uniform Table; see also "*Election of life expectancy method ceases to exist*," below.

This means that a client's choice of beneficiary can now be made based solely on post-death planning considerations, without concern that leaving benefits to the beneficiary who is the best choice for *post-death distributions* will accelerate required distributions to the participant *during life*. For example:

A. If the participant has no designated beneficiary—it doesn't matter; he still uses the Uniform Table. Thus, the drawback of naming charity as a beneficiary at age 70½ is *totally eliminated*. See "*Naming a Charity as Beneficiary at RBD*," page 283 of *Life and Death Planning for Retirement Benefits*. The lifetime drawback of naming the participant's estate as beneficiary is eliminated (though it is still in most cases a drawback for post-death distributions; see "*Distributing the account itself out of an estate*," below).

B. If the participant's beneficiary is the same age as (or older than) the participant—it doesn't matter; the participant can still use the Uniform Table. Thus, the old regime's "punishment" for naming a same-age spouse (rather than younger-generation individuals, such as children or grandchildren) as beneficiary is totally eliminated. Participants who want to provide for their time-tested spouses and elderly relatives can do so without having to pay increased income taxes because of their choice.

Under the (bad old) rules, required distributions after age 70½ were based on the joint and survivor life expectancy of the participant and his designated beneficiary (determined as of the required beginning date—or as of any later date on which the participant switched to a less "favorable" beneficiary). If the participant had no designated beneficiary (for example, because his benefits were left to his estate or a charity) as of his RBD (or such later date) he was forced to use his single life expectancy (15.3 or 16 years at the RBD) to measure distributions.

If the participant's spouse was his designated beneficiary, he used the joint and survivor life expectancy of himself and his spouse; while this could be as long as 50 years if the spouse were much younger than the participant, the average participant's spouse was close in age to himself, resulting in a payout over 19-22 years in most cases. If and only if the participant's beneficiary were a younger generation non-spouse individual, could the participant use the favorable "MDIB rule table." Few retirees managed to qualify for this favorable treatment. Under the new proposed regulations, everyone qualifies for it.

Lifetime distributions if DB is much-younger spouse

"If the sole designated beneficiary of an employee is the employee's surviving spouse, for required minimum distributions during the employee's lifetime, the Applicable Distribution Period is the longer of the distribution period determined in accordance with [the Uniform Table] or the joint life expectancy of the employee and spouse using the employee's and spouse's attained ages as of the employee's and the spouse's birthdays in the distribution calendar year." P.R. § 1.401(a)(9)-5, A-4(b). Note that this formulation mandates annual recalculation of the participant's and spouse's life expectancies.

For discussion of the rules that apply if the spouse is not (or may not be) the sole beneficiary, see "*The spouse, individually, is one of multiple beneficiaries*" below and "*When is a trust for the spouse the same as the spouse?*" (In the other outline, # 19).

So, the advantage of marrying a young spouse and naming her as sole designated beneficiary still exists: a participant who names his more-than-10-years-younger spouse as his sole beneficiary uses the real joint and survivor life expectancy of himself and the much-younger spouse, which will produce larger "divisors" and smaller required distributions than the Uniform Table. The participant's minimum required distribution (MRD) in this situation will be the MRD indicated by the Uniform Table, or that indicated by the joint and survivor life expectancy of the participant and spouse, whichever is smaller.

The Preamble to the proposed regulations states that the employee is "permitted" to use the longer life expectancy in this situation, but the concept of a *choice* in calculating minimum *required* distributions is an oxymoron. The *required* distribution is whichever is smaller—the one produced by the Uniform Table or the one produced by the true joint life expectancy.

Similarly, the Preamble speaks of an employee "taking advantage" of a lifetime distribution period measured by the joint life expectancy of the employee and much-younger spouse ("Determination of designated beneficiary"), again making it sound as though (in order to have MRDs determined under joint life expectancy of participant and spouse) the participant must not only marry a much younger spouse, and not only name her as his sole designated beneficiary, he must take some additional step to somehow elect to use the joint life expectancy of himself and the spouse. Despite these statements in the preamble, however, the regulation itself does not give the participant a choice of how to determine his required distributions. If he has named a much-younger spouse as his sole beneficiary, required distributions ARE based on the joint life expectancy of participant and spouse, not on the Uniform Table.

Spouse-as-sole-beneficiary determined year-by-year

The spouse is "sole designated beneficiary" for purposes of determining the participant's required distributions "if the spouse is the sole beneficiary of the employee's entire interest at all times during the distribution calendar year." P.R. § 1.401(a)(9)-5, A-4(b). Hopefully, the IRS will fix this up a bit so that if the spouse ceases to be the sole beneficiary because of her death or divorce during the distribution year, she will still be considered "sole beneficiary" at least for the rest of that distribution year. This would be consistent with the overall approach of making changes in status effective in the year following the change.

But regardless of whether the IRS patches up this rule so that changes of status have no effect until the following distribution year, the new rule still represents a change from the old rules, in that the determination of whether the participant will use the Uniform Table or the true joint life expectancy of himself and a much-younger spouse is made *year-by-year*, rather than being carved in stone on the required beginning date (as under the old rules). Under this new rule, if the much-younger spouse predeceases the participant, or they get divorced, the participant then has to go back to using the Uniform Table. Under the *old* proposed regulations, divorce did not terminate a beneficiary's status as "spouse" for purposes of calculating minimum distributions; nor did death, unless the participant had elected to recalculate the spouse's life expectancy.

Similarly, under this rule, a participant who marries a much-younger spouse *after* the participant's RBD can switch, the next year, from the Uniform Table to the true joint and survivor life expectancy of himself and the new spouse. This type of switch did not appear possible under the old proposed regulations. See Old P.R. § 1.401(a)(9)-2, A-7(d); and "*Changing marital status after RBD*," page 45 of *Life and Death Planning for Retirement Benefits*."

The new year-by-year rule for determining the status of the spouse as sole beneficiary provides one of the few instances in which a participant can be worse off under the new rules than under the old:

Example: Gaston turned age 70 and age 70½ back in 1998. On his required beginning date, his sole designated beneficiary was his wife Sonia, who reached age 43 in 1998, so Gaston's required distributions were based on the joint life expectancy of himself and Sonia (40.1 years in 1998). Gaston elected to take distributions using the fixed term method for both spouses' life expectancies. Sonia dies in 2001. Under the old rules, her death would not affect Gaston's required distributions, which would continue to be based on what was left of the spouses' 40.1-year fixed term joint life expectancy, so, under the old rules, Gaston's divisor for 2002 would be 36.1 (40.1 minus four elapsed years). Under the new rules, however, Gaston has to use the Uniform Table because his spouse is no longer his designated beneficiary. Although this is an unusual fact pattern (participant names much-younger spouse as sole beneficiary, and much-younger spouse then predeceases much-older participant), there are bound to be a few Gastons out there, and we will see if they protest vigorously enough to persuade the IRS to create a special "grandfather" rule for them.

Election of life expectancy method ceases to exist

The new proposed regulations eliminate the participant's (and surviving spouse's) option to elect a method of determining life expectancy. Instead, joint recalculation is mandatory during the participant's lifetime, whether he is using the Uniform Table (which is made up of joint life expectancies—redetermined annually—of a participant age 70 or older and a hypothetical beneficiary 10 years younger than the participant), or the real joint life expectancy of himself and his much-younger spouse (see "*Lifetime distributions if DB is much younger spouse*," above).

The divisors in the old MDIB Rule/new Uniform Table represent the joint life expectancy of a participant age 70 (or older) and a beneficiary who is ten years younger than the participant, with both life expectancies *redetermined annually*. In other words, the table does not start with a 26-year life expectancy (divisor) and then reduce it by one each year. If the table used such a "fixed term method," then all money would have to be distributed out of the plan by the time the participant reached age 96 (70 + 26). Instead, the table's factors are recomputed annually, so the divisor decreases by less than one each year. At age 75, the divisor is 21.8 (not 21), at age 89 it is 11.1 (not 7). The divisor never goes below 1.8 (age 115 and older).

This means that, regardless of how long the participant lives, the account will never go down to zero (if the participant takes only the minimum required distribution, and has positive investment results). Under this table, even at age 114 the required distribution is only ½ of the account. Thus, under the new rules, the benefits of recalculating life expectancy are available to EVERYBODY, without the necessity of making an election.

Under the old system, as under the new, recalculating life expectancy annually produced the longest "stretch out" of the retirement plan distributions during life: as long as the participant (or the spouse) was alive, had positive investment returns, and took only the required minimum distribution, the plan could not run out of money. But under the old rules this desirable feature came with a price: once death occurred, the life expectancy of the deceased person "went to zero" under the recalculation method, and there would be nothing left of that person's life expectancy that the beneficiaries could use to measure *their* distributions.

The new proposed regulations eliminate this drawback of the "recalculation method." Now if the participant dies after his required beginning date the benefits are distributed over the life expectancy of the designated beneficiary (determined at or after the date of death), or, if there is no designated beneficiary, over the remaining *fixed-term* life expectancy of the participant. See "*How to compute distributions: death on or after the RBD*," below.

Example: Jonathan dies at age 87 leaving his $5 million IRA to a non-qualifying trust. Assume that for some reason the trust's defects cannot be cured by the end of the year after Jonathan's death, so Jonathan has died with "no designated beneficiary." This means that Jonathan's remaining single life expectancy must be used by the trust to measure required distributions from the IRA to the trust after Jonathan's death. Since Jonathan had been using the Uniform Table, he was in effect recalculating his life expectancy annually (because recalculation is built into the table). Under the *old* rules, a recalculated life expectancy would go to zero upon death, meaning (in the case of Jonathan's IRA) that the trust, under the old rules, would have had to withdraw 100% of the balance of the IRA by the end of the year following Jonathan's death. (See page 53 of *Life and Death Planning for Retirement Benefits* for full explanation.) Under the new rules, however, Jonathan's life expectancy does not simply disappear at his death, *even though* his life expectancy was in effect being redetermined annually (recalculated) during his life. Instead, the calculation of his life expectancy switches to a fixed-term method for distributions after his death. The opening term of this fixed-term Applicable Distribution Period is Jonathan's life expectancy (from Table V, the IRS single life expectancy table) as of his birthday in the year death occurred, i.e., for an 87-year-old, 6.1 years, reduced by one elapsed year, so the initial Applicable Distribution Period is 5.1.

Despite the fact that the new proposed regulations will abolish the election of a method of determining life expectancy, the Preamble refers to "an employee who elects or defaults into" recalculation of life expectancy ("Determination of designated beneficiary").

Planning implications of the new method

The new rules will result in "reducing the required minimum distributions for the vast majority of employees." P.R., Preamble, "Overview." This is good news for: Wealthy retirees who don't need to draw down large sums from their plans to live on and would like to minimize current income taxes; for less wealthy retirees who are trying to conserve their retirement plans as much as possible and stretch their funds out over a long post-retirement lifetime; and for the retirees' money managers, who will be able to keep managing their clients' money that much longer.

The new method of determining lifetime required distributions is so simple that the need for the assistance of software programs and professional advice *on this particular point* is vastly reduced if not eliminated. Natalie Choate, Greg Kolojeski, Barry Picker and others who heretofore have spent considerable time worrying about what participants should do at age 70½ will now have plenty of free time.

It still remains extremely important (and potentially profitable for the participant's heirs) to make the right choice of "designated beneficiary" to maximize tax deferral opportunities available to the heirs after the participant's death. The difference is that the best choice of designated beneficiary now won't change just because the participant reaches his required beginning date. There will no longer be a pressing need to evaluate choices (such as whether to divide a retirement plan into separate accounts) *just because* the client is reaching his required beginning date.

The only continued significance of contacting clients before the year they reach 70½ appears to be: to notify them of the MRD requirements (so they can comply and avoid penalties); and to suggest a final look at the possibility of a Roth IRA conversion before MRDs kick in (since required distributions, once they start in the age-70½ year, may increase the client's income above $100,000 per year, and render him no longer eligible to convert to a Roth IRA).

The major immediate planning implication is that any person who is past his or her required beginning date (or who reached age 70 ½ in the year 2000, or who will reach it in 2001) should investigate the new rules *before taking his or her required distribution for the year 2001.* The new rules offer most (though not all) participants and beneficiaries a more favorable way for determining required distributions.

Also, any person who is past his required beginning date should review his choice of beneficiary, since there is now a chance to change to a more favorable choice of "designated beneficiary" for post-death distributions. See "*Designated beneficiary is determined at death, not at RBD*," below. Under the old rules, such changes were not possible after the required beginning date.

The New Way to Determine Post-Death Distributions

Designated beneficiary determined at death, not at RBD

A major "gotcha" feature of the old rules was that, while post-death required distributions were in theory based on the life expectancy of the beneficiary, many beneficiaries who actually inherited retirement plans and IRAs could not use their life expectancies to measure required distributions, because the determination of who was the participant's "beneficiary" was made, in the case of a participant who had passed his required beginning date, as of the required beginning date, *not* the date of death. Furthermore, even if the participant had a proper "designated beneficiary" on the required beginning date, a favorable life expectancy payout still might not be available to the beneficiary who later actually inherited the account, if the participant had changed his choice of beneficiary after the required beginning date to someone older than the original designated beneficiary (or to "no designated beneficiary").

The new proposed regulations totally scrap this scheme. Under the new rules, required distributions to the beneficiaries who actually inherit the benefits are—sensibly—based on the life expectancies of...*the beneficiaries who actually inherit the benefits!* No longer will there be any need to look back to the participant's choices at some long-past required beginning date. In determining post-death required distributions, the choice of beneficiary at the required beginning date is now officially: *irrelevant*! Once again, it appears that the IRS (in the interest of simplification) has bypassed the statutory scheme, in this case ignoring the "at least as rapidly" rule of § 401(a)(9)(B)(i) (see page 40 of *Life and Death Planning for Retirement Benefits*).

In another major innovation of the new proposed regulations, the identity of the participant's beneficiary is not "finalized" for purposes of computing minimum required distributions until the end of the year following the participant's death. The nature of this rule and its planning implications are discussed in the next major section of this outline, "Identity of DB Determined at End of Year after Death," below. The rest of *this* section explains how to calculate required distributions after the participant's death, once it is finally determined (at the end of the year following the participant's death) who the participant's "beneficiary" is.

How to compute distributions: death before the RBD

Once the identity of the beneficiary is finalized (on the Designation Date), here is how to determine the beneficiary's (or beneficiaries') distribution options, if the participant died before his required beginning date. Note that, except for the new creative "recalc/fixed term-combo" method of determining the surviving spouse's life expectancy, this is basically unchanged from the 1987 proposed regulations.

A. Spouse is sole designated beneficiary: If there is one individual beneficiary, and that beneficiary is the participant's surviving spouse, then the spouse must take required distributions either (a) under the 5-year rule (see "D"), or (b) over her life expectancy beginning no later than the later of: (i) December 31 of the year the deceased participant would have reached age 70½ or (ii) December 31 of the year after the year in which the participant died. P.R. § 1.401(a)(9)-3, A-3(b). If the surviving spouse, having inherited the benefits as sole beneficiary, and having survived until the Designation Date, dies before the required date for commencement of a life expectancy payout to her, the post-death distribution rules will be applied generally "as if" the surviving spouse were the participant and died before her RBD. For the ins and outs of this rule, see "Special Rules for the Surviving Spouse," below. If the surviving spouse, having inherited the benefits as sole beneficiary, and having survived until the Designation Date, does *not* die before the required commencement date for distribution of benefits to her under the life expectancy payout method (and does not, before that date, roll over the benefits to her own IRA, or—in the case of an inherited IRA—elect to treat such IRA as her own), then she must start taking distributions by that date over the "Applicable Distribution Period," which is the surviving spouse's life expectancy. For how to calculate this, see "*How to compute life expectancy of surviving spouse*," below.

B. One, non-spouse, designated beneficiary: If there is one individual beneficiary, and that beneficiary is not the participant's surviving spouse, then the beneficiary must take required distributions either (a) under the 5-year rule (see "D"), or (b) over the beneficiary's life expectancy (see "*How to compute life expectancy of non-spouse beneficiary*," below), beginning no later than the end of the year after the year in which the participant died. P.R. § 1.401(a)(9)-3, A-3(a).

C. Multiple individuals: If there are multiple beneficiaries (and they have not managed to establish "separate accounts" by the Designation Date) (see "E" below), and they are all individuals, then (even if one of them is the participant's surviving spouse), they must take distributions either (a) under the 5-year rule (see "D"), or (b) over the life expectancy of whichever member of the group has the shortest life expectancy (in other words, the oldest member of the group), beginning no later than the end of the year after the year in which the participant died. P.R. § 1.401(a)(9)-3, A-3(a); -4, A-4(c); -5, A-7. See "*How to compute life expectancy: multiple beneficiaries*," below.

D. The 5-year rule: If there is one beneficiary, and that beneficiary is not an individual; or, if there are multiple beneficiaries (and they have not managed to establish "separate accounts" by the Designation Date) (see "E" below), and any of them is not an individual (even if one of them is the participant's surviving spouse); then the participant is treated as having "no designated beneficiary." In this case all benefits must be distributed under the "5-year rule," which means no later than December 31 of the year that contains the fifth anniversary of the date of death. P.R. § 1.401(a)(9)-3, A-1(b) and A-2; -4, A-3(b) and A-4(c); -5, A-7.

E. Separate accounts rule: If there are multiple beneficiaries, but their respective shares of the benefits are divided into "separate accounts" as of the Designation Date, the above rules are applied separately to each such "separate account." P.R. § 1.401(a)(9)-8, A-3. See "*Establishing separate accounts after death*," below.

In each of the above cases, if the surviving spouse is a beneficiary, the surviving spouse has the option to roll over the benefits payable to her tax-free to an IRA in her own name. See Chapter 3 ("Marital Matters") of *Life and Death Planning for Retirement Benefits*.

How to compute distributions: death on or after the RBD

Once the identity of the "beneficiary" is finalized (on the Designation Date), here is how to determine the beneficiary's (or beneficiaries') distribution options, if the participant died on or after his required beginning date.

First, the minimum distribution for the year in which the participant died is still based on the deceased participant's required distribution schedule. P.R. § 1.401(a)(9)-5, A-4(a)(1). Thus, if the deceased participant had not yet taken the minimum distribution for the year of his death, the beneficiary(ies) must take out that distribution before the end of the year in which death occurred, using the method the decedent was using to calculate distributions (Uniform Table or Table VI).

Required distributions beginning in the year *after* the year of death will be based on an "Applicable Distribution Period." § 1.401(a)(9)-2, A-5; -5, A-5(a). The rules for determining the Applicable Distribution Period when the participant died after his RBD are now almost exactly the same as the rules for post-death distributions in case of death before the RBD. The only differences are: items relevant only in case of death before the RBD (the 5-year rule, and the special spousal rules of § 401(a)(9)(B)(iv)) are eliminated; a new interpretation of what happens if the participant has no designated beneficiary is added (see "D"); and the question of when "separate accounts" may be established is unsettled.

A. Spouse is sole beneficiary: If the surviving spouse is the sole beneficiary, and the deceased participant was not using the "Special rule for much younger spouse as sole beneficiary" (see "B"), then the Applicable Distribution Period is the surviving spouse's life expectancy. P.R. § 1.401(a)(9)-5, A-5(a). For how to calculate this, see "*How to compute life expectancy of surviving spouse*," below.

B. Much younger spouse is sole beneficiary: The Preamble to the Proposed Regulations (under "Determination of Designated Beneficiary") states that, under the new proposed regulations, in the case of death on or after the RBD, "Any prior beneficiary designation is irrelevant" for purposes of computing post-death required distributions, "*unless* the employee takes advantage of a lifetime distribution period measured by the joint life expectancy of the employee and a spouse more than 10 years younger" (emphasis added). This clause in the Preamble suggests that post-death required distributions to the surviving spouse-beneficiary are calculated differently depending on whether the surviving spouse was or was not more than ten years younger than the participant. However, this author finds no such distinction in the actual Proposed Regulations. Therefore, apparently, calculation of minimum required distributions to a much-younger surviving spouse is the same as in any other case where the surviving spouse is the sole beneficiary. See "*How* *to compute life expectancy of surviving spouse*," below. P.R. § 1.401(a)(9)-5, A-5(a).

C. One, non-spouse, individual beneficiary: If there is one individual beneficiary, and that beneficiary is not the surviving spouse, then the "Applicable Distribution Period" is the individual beneficiary's life expectancy. See "*How to compute life expectancy of non-spouse beneficiary*," below.

D. Multiple individual beneficiaries: If there are multiple beneficiaries, and they are all individuals, then (unless the "separate accounts" rule applies; see "F," below) they must take required distributions over the life expectancy of the member of the group who has the shortest life expectancy (in other words, the oldest beneficiary). P.R. § 1.401(a)(9)-4, A-4(c); -5, A-7. See "*How to compute life expectancy: multiple beneficiaries*," below.

E. No designated beneficiary: If there is one beneficiary, and that beneficiary is not an individual; or, if there are multiple beneficiaries, and any of them is not an individual (even if one of them is the participant's spouse); then (unless the "separate accounts" rule applies; see "F," below) the participant is treated as having "no designated beneficiary." P.R. § 1.401(a)(9)-4, A-4(c); -5, A-7. In this case the Applicable Distribution Period is the remaining years of the *participant's* life expectancy, determined as follows. First, determine the participant's single life expectancy, using the IRS's single life expectancy table (Table V), based on the age the participant had attained (or would have attained had he lived long enough) on his birthday in the year of his death. The life expectancy for the year of the participant's death, reduced by one year, is used as the "divisor" for the first distribution year (i.e., the year *after* the participant's death), and the divisor is reduced by one each year thereafter (fixed-term method). P.R. § 1.401(a)(9)-4, A-3(b) and § 1.401(a)(9)-5, A-5(c)(3). This is one of the major innovations of the new proposed regulations. The participant gets the benefit of the "recalculation" method of determining life expectancy during his lifetime (whether he is using the Uniform Table or joint life expectancy with his spouse, he can never "outlive" the benefits by running out of life expectancy); but after his death, the life expectancy calculation switches to the "fixed-term" (also called "reduce-by-one") method, "thus allowing distributions in all cases to be spread over a number of years after death." P.R., Preamble, "Overview." See "Jonathan" example under "*Election of life expectancy method ceases to exist*," above

F. Separate accounts rule: P.R. § 1.401(a)(9)-8, A-3, generally provides that if the participant's account has been divided into "separate accounts" payable to different beneficiaries, the above rules are applied separately to each such "separate account." However, Guerdon Ely has pointed out that, in case of death after the RBD, the proposed regulations read literally either require that such separate accounts be established on or before the required beginning date in order to be recognized for post-death distributions or do not allow separate accounts at all. See

P.R. § 1.401(a)(9)-8, A-2(a), (b). This runs contrary to the theme of the rest of the new proposed regulations, which make the RBD irrelevant for determining the identity of the beneficiary of post-death distributions, so presumably this is a mistake. See "Anomalies," below.

How to compute life expectancy of surviving spouse

If the participant's sole beneficiary at his death is his surviving spouse, then one of the following four rules applies:

First, regardless of whether the participant died before, on or after his required beginning date, the surviving spouse can roll the benefits over to her own IRA (or, in the case of an inherited IRA, elect to treat it as her own IRA). The surviving spouse does not have to wait until the "Designation Date" to do the rollover or election; she can do this anytime after the participant's death (provided, if the participant died after his RBD, that she first takes out the MRD for the year of death, if the participant had not done so). The resulting IRA is treated as the spouse's own IRA and all minimum distribution rules based on the original deceased participant no longer apply. See "Special Rules for Surviving Spouse," below for full details.

Second, if the spouse survives the participant, but then dies before the Designation Date, without having rolled over the benefits to her own IRA (or, in the case of an inherited IRA, elected to treat it as her own IRA), then she will not be the beneficiary as of the Designation Date, and none of the special spousal rules will apply. See "*Effect of beneficiary's death prior to Designation Date*," below, for problems created by the death of the beneficiary prior to the Designation Date.

Third, *if* the participant died before the year in which he would have reached age 69½, *and* the surviving spouse lived until the Designation Date, but then she also dies, and her death occurs before December 31 of the year the participant would have reached age 70½ , then a special rule applies, namely, § 401(a)(9)(B)(iv), discussed below under "Special Rules for the Surviving Spouse."

Finally, in all other situations (i.e., the participant died after the year in which he reached age 68½, leaving benefits to surviving spouse as sole beneficiary and she survived to the Designation Date; or the participant died before the year he would have reached age 69½, but the surviving spouse lived until December 31 of the year the participant would have reached age 70½; *and* the surviving spouse has not rolled over the benefits to her own IRA, or, in the case of an inherited IRA, elected to treat the inherited IRA as her own IRA), required distributions must be made over the surviving spouse's life expectancy.

However, the life expectancy of the surviving spouse as sole beneficiary is not computed in the same way as the life expectancy of a non-spouse beneficiary. In one of the innovations of the new proposed regulations, the spouse's life expectancy is determined by a combination of recalculation and fixed-term methods. During the surviving spouse's lifetime, the surviving spouse must take her required distributions over her life expectancy, *recalculated annually*, beginning in whatever year she is required to begin distributions. (For when the surviving spouse is required to commence taking distributions, see "Special Rules for the Surviving Spouse," below.) When the surviving spouse herself later dies, any benefits remaining in the original participant's plan must be paid out over the remaining (*fixed term*) life expectancy of the surviving spouse, computed as of her age on her birthday in the year of her death. P.R. § 1.401(a)(9)-5, A-5(a)(1), (b), and (c)(2).

This convoluted rule is very favorable to the surviving spouse and her heirs, because it gives them the advantage of recalculation without the drawbacks. It probably will not come into play very often, since most surviving spouses choose to roll over inherited retirement benefits.

Example: Harry dies in 2003 at age 75 leaving his 401(k) plan entirely to his wife Grace. Harry had taken his MRD for 2003 prior to his death. For some reason, Grace decides not to roll over the 401(k) plan to her own IRA; she leaves it in Harry's name. As long as it stays in Harry's name, Grace's required distributions each year (beginning with the year 2004) are computed based on Grace's life expectancy as of her birthday in such year (recalculation method). For example, assume that her age on her 2004 birthday will be 76. The single life expectancy of someone age 76 (from the IRS Single Life Expectancy factor table, Table V—see IRS Publication 590) is 11.9, so her required distribution from the 401(k) plan for the year 2004 is the 2003 year-end account value divided by 11.9.

Now Grace dies in 2005. Although she died before actually reaching her year-2005 birthday, we look at the age she *would have attained* in 2005 (which is not necessarily her age at her death) to calculate required distributions for the year of her death and later. She would have attained age 77 on her birthday in the year 2005 had she lived. The minimum required distribution for the year of her death is based on the single life expectancy of someone age 77 (11.2 years). Her life expectancy is then "frozen" at 11.2 years because of her death. Minimum distributions to her successor beneficiaries thereafter will be based on this 11.2-year life expectancy, using the "fixed term" (also called "reduce-by-one") method.

Assume Grace had not taken the year-2005 MRD before she died. Her successor beneficiaries must now take the 2005 distribution, which is the 2004 year-end account value divided by 11.2; and in 2006 they will take the 2006 MRD, which is the 2005 year-end account value also divided by 11.2. In other words, the first year after the year of her death the MRD divisor is the same as the MRD divisor for the year in which she died, namely, 11.2 in this example. (For further discussion of this point, see "*Anomalies: three different methods of determining single life expectancy*," below.) For the second year after her death, the divisor will be 10.2.

If Grace had rolled over the inherited account to her own IRA, she could have named her own designated beneficiaries, and they would have been able to use their own life expectancies for required distributions, instead of being limited to just using the rest of Grace's life expectancy.

How to compute life expectancy of non-spouse beneficiary

If there is a single "designated beneficiary," who is not the surviving spouse, the Applicable Distribution Period is the life expectancy of the designated beneficiary, determined based on his or her age on his or her birthday in the year after the year in which the participant died, and reduced by one each year thereafter. This method applies regardless of whether the participant died before, on or after his required beginning date. These post-death required distributions begin the year after the year of death; in other words, the beneficiary's first "distribution year" is the year after the participant's death.

If the participant was already subject to the requirement of taking required distributions, the required distribution for the year of death is still based on whatever method the participant was using prior to death—the Uniform Table or the joint life expectancy of the participant and his or her spouse; the required distribution for the year of death must be taken by the beneficiaries if the participant had not yet taken it at the time of his death. P.R. § 1.401(a)(9)-3, A-3(a); -5, A-5(a)(1) and A-5(b)(c)(1); and -5, A-7.

Example: Jack dies in 2002. Dennis, who is not Jack's spouse, is the sole beneficiary of the account as of the Designation Date, December 31, 2003. Dennis turned 65 on his birthday in the year 2003. The single life expectancy of a person age 65 (according to IRS Table V—see IRS Publication 590) is 20.0. By the end of 2003, Dennis must withdraw from the IRA at least 1/20th of the 12/31/2002 account balance. If Jack died after April 1 of the year following the year in which he reached age 70 ½, and Jack had not withdrawn the MRD for 2002 by the time of his death, the beneficiary must also withdraw the balance of the 2002 MRD (computed using the Uniform Table and Jack's age as of Jack's birthday in 2002—regardless of whether Jack died before or after his 2002 birthday, or using the actual joint life expectancy of Jack and Jack's spouse as of their 2002 birthdays, if Jack's more-than-10-years-younger spouse was his sole designated beneficiary throughout the year 2002) prior to the end of 2002.

How to compute life expectancy: multiple beneficiaries

If there are multiple beneficiaries as of the Designation Date, and the separate accounts rule does not apply, the Applicable Distribution Period is the life expectancy of the oldest designated beneficiary (beneficiary with the shortest life expectancy), determined based on his or her age on his or her birthday in the year after the year in which the participant died, and reduced by one each year thereafter. This method applies regardless of whether the participant died before, on or after his required beginning date, and regardless of whether the surviving spouse is one of the beneficiaries or is the oldest designated beneficiary.

These post-death required distributions begin the year after the year of death; in other words, the beneficiaries' first "distribution year" is the year after the participant's death. If the participant was already subject to the requirement of taking required distributions, the required distribution for the year of death is still based on whatever method the participant was using prior to death—the Uniform Table or the joint life expectancy of the participant and his or her spouse; the required distribution for the year of death must be taken by the beneficiaries if the participant had not yet taken it at the time of his death. P.R. § 1.401(a)(9)-3, A-3(a); -5, A-5(a)(1) and A-5(b)(c)(1); and -5, A-7.

Example: Percy dies in 2002. As of the Designation Date (December 31, 2003), the beneficiary of the account is Percy's testamentary trust, which is a trust for the benefit of Percy's wife Olivia for life, with remainder to Percy's children at Olivia's death. The trust complies with the four "trust rules" (see "Benefits Payable to a Trust," below), and Olivia (who turns 65 on her 2003 birthday) is the oldest beneficiary of the trust as of the Designation Date. The single life expectancy of a person age 65 (according to IRS Table V—see IRS Publication 590) is 20.0. By the end of 2003, the trust must withdraw from the IRA at least 1/20th of the 12/31/2002 account value.

Loss of joint life expectancy payout hurts some beneficiaries

Although for most participants and beneficiaries the new rules produce better results (smaller required distributions) than the old rules, the new method of computing post-death required distributions will actually produce larger required distributions for some beneficiaries who inherit benefits from a participant who died after his RBD, because the new rules require all beneficiaries to use a *single* life expectancy period to measure required distributions. Under the old rules, if various requirements were met, a beneficiary who inherited benefits from a participant who died after the RBD used the remaining *joint* life expectancy of the participant and the beneficiary.

Since the joint life expectancy of two individuals is necessarily longer than the single life expectancy of one of them, it would at first appear that the new rules would *always* produce a *worse* result for a beneficiary inheriting from a participant who died after his RBD. In fact, few beneficiaries will feel a significant adverse impact, for the following reasons:

1. Spousal rollover mitigates loss of joint life expectancy payout. A surviving spouse can mitigate the adverse effect by rolling over the benefits to her own IRA (from which MRDs to her can be based on the Uniform Table rather than her single life expectancy). However, since this option will generally not be available if the beneficiary is a trust for the surviving spouse (rather than the surviving spouse individually) (see "*When is a trust for the spouse the same as the spouse?*" in outline # 19), the change in the rules can be a disadvantage of leaving retirement benefits to a trust. See, generally, "Special Rules for the Surviving Spouse," below.

2. Substantial age difference mitigates loss of joint life expectancy payout. Because of the substantial age difference, the *typical* much-younger non-spouse beneficiary such as the participant's child (or grandchild) will notice little difference between the *joint* life expectancy of the participant and the child (or grandchild) (which could have been used under the old rules) and the *single* life expectancy of the child (or grandchild) (which will be the only available option under the new rules). For example, the joint and survivor life expectancy factor for a 70-year-old participant and his 45-year-old son is 38.3, while the single life expectancy factor for the 45-year-old son is 37.7 years, a difference of only .6. The loss of .6 years from the divisor is hardly worth noticing. If the designated beneficiary is closer in age to the participant, however, the difference between the joint life expectancy of participant and beneficiary versus the single life expectancy of the beneficiary becomes more noticeable. For example, a beneficiary who is the same age as the participant would certainly "notice" the difference between the joint and survivor life expectancy of two people age 70 (20.6 years) and the single life expectancy of one person age 70 (16.0 years), a "loss" of 3.4 years of life expectancy that the beneficiary can use for determining his or her MRDs.

3. Change of starting point for determining beneficiary's life expectancy mitigates loss of joint life expectancy. Under the new rules, the starting point for determining the beneficiary's life expectancy is the beneficiary's age as of his or her birthday *in the*

> *year after death*. Under the old rules, the starting point for determining the joint life expectancy of the participant and beneficiary was the *year before the required beginning date*. This change in the starting point reduces the negative impact of the loss of a joint life expectancy factor, if the participant lives for many years past the RBD. For example, consider the participant whose non-spouse beneficiary is exactly his same age, and who elected the fixed term life expectancy method under the old rules, then died at age 84. Under the old rules, the beneficiary (now age 84 himself) would have had to take out the benefits over 6.6 years (original 20.6 year joint life expectancy of two people age 70, minus 14 elapsed years since the year before the RBD). Under the new rules, his MRDs beginning the year after the participant's death are based on the beneficiary's single life expectancy as of his birthday in that year. Since he will be age 85 in the year after the participant's death, his single life expectancy will be 6.9 years, which is *longer* than he would have had under the old rules. Only if the participant dies before age 84 will his same-age designated beneficiary have larger required distributions under the new method than under the old.

While some beneficiaries of participants who die after the RBD unquestionably will be worse off under the new rules (in the sense of having larger required distributions), the vast majority of beneficiaries will win under the new rules: smaller required distributions during the participant's life (under the Uniform Table) will mean there is more in the plan for the beneficiary to inherit; the ability to modify beneficiary designations right up to the moment of (and even after) death will mean that many more beneficiaries actually qualify for the single life expectancy payout (as opposed to very few beneficiaries who found themselves successfully qualifying for a joint life expectancy payout under the old rules); and the disappearance of the "recalculation" gamble will mean that no beneficiary will ever again have to suffer the dreaded "one-year rule" (see, e.g., "*Installments over P's LE: recalculation method*," at page 53 of *Life and Death Planning for Retirement Benefits*).

Anomalies: having a DB can be worse than no DB

If a participant dies on or after his RBD, leaving his benefits to a designated beneficiary, and the designated beneficiary was born in a year earlier than the year of the participant's birth, the life expectancy of the designated beneficiary will actually produce a faster payout than would have been required if the participant had left no designated beneficiary (because the beneficiary's life expectancy is shorter than the participant's life expectancy). Perhaps the IRS will change the rules to permit the participant's remaining life expectancy to be used instead of the designated beneficiary's life expectancy, in other words, establishing the participant's remaining life expectancy as a "floor."

Anomalies: separate accounts in case of death after RBD

The Preamble ("Determination of Designated Beneficiary") says that the new regs provide "the same rules for distributions after the employee's death, regardless of whether such death occurs before or after" the RBD. The Preamble also states that "If, as of the end of the year following the year of the employee's death, the employee has more than one designated beneficiary and the account or benefit has not been divided into separate accounts or shares for each beneficiary, the beneficiary with the shortest life expectancy is the designated beneficiary," which suggests that the separate accounts determination is made on the Designation Date and does not suggest that this result applies only if death occurred before the required beginning date. Yet, P.R. § 1.401(a)(9)-8, A-2(a) states that separate accounts are aggregated "except as otherwise provided in" subparagraph (b), and subparagraph (b) does not provide any specific contrary rule for *post-death* distributions where death occurs after the required beginning date. Subparagraph (b) provides a specific contrary rule only for *lifetime* required distributions where death occurs after the required beginning date. In view of the statements in the Preamble, it appears that P.R. § 1.401(a)(9)-8, A-2(a) is a technical glitch and that the IRS intends to say that "separate accounts" can be established during the post-death cleanup period whether death occurred before or after the required beginning date.

Anomalies: three different methods of determining single life expectancy

Marcia Chadwick Holt has pointed out that there are three situations in which the Applicable Distribution Period for post-death distributions is a single life expectancy; and that the Proposed Regulations provide a different method for determining this single life expectancy in each of the three situations.

If the participant died after his RBD, with no designated beneficiary, the Applicable Distribution Period beginning in the first distribution year (i.e., the year after the year in which the Participant died) is the participant's single life expectancy determined *as of his birthday in the year of his death reduced by one year*. If the participant died leaving his benefits to an individual (non-spouse) designated beneficiary, the Applicable Distribution Period beginning in the first distribution year (i.e., the year after the year in which the Participant died) is the beneficiary's single life expectancy determined *as of his birthday in the first distribution year*. And if the participant died leaving his benefits to his surviving spouse as sole designated beneficiary, and the surviving spouse died after the Designation Date but before having rolled over the benefits to her own IRA (or, in the case of an inherited IRA, before having elected to treat the inherited IRA as her own IRA) the Applicable Distribution Period beginning in the distribution year following the year in which the surviving spouse died is the spouse's single life expectancy determined *as of her birthday in the year of her death NOT reduced by one year*.

Identity of DB Determined at End of Year after Death

Designated beneficiary determined at end of year after death

In another major innovation, the new proposed regulations specify that the date for determining who is the employee's "designated beneficiary" is not the date of death or required beginning date. Rather, "the employee's designated beneficiary will be determined based on the beneficiaries designated as of the last day of the calendar year following the calendar year of the employee's death." § 1.401(a)(9)-4, A-4(a). This change in the rules is likely to get garbled in the press. In fulfilment of the preceding prediction, the following appeared in a newspaper the day after I wrote it: "Under the new rules, the deadline for designating a beneficiary is...Dec. 31 after the year of the account holder's death...This can be done via written instructions from the account holder [from the grave apparently] or his executor."

Of course, that is not correct. The participant's beneficiary selections are "carved in stone" the moment the participant dies. Post-death planning cannot simply designate new beneficiaries. All that can be done between the date of death and the end of the next year is, so to speak, to re-arrange the stones. As the IRS says it: "Consequently...any person who was a beneficiary as of the date of the employee's death, but is not a beneficiary as of that later date (e.g., because the person disclaims entitlement to the benefit in favor of another beneficiary or because the person receives the entire benefit to which the person is entitled before that date) *is not taken into account* in determining the employee's designated beneficiary for purposes of determining the distribution period for required minimum distributions after the employee's death." P.R. § 1.401(a)(9)-4, A-4(a) (emphasis added).

In other words, *if* there are "good" beneficiaries (i.e., younger generation individual beneficiaries with long life expectancies) who are *already named* by the deceased participant (e.g., as contingent beneficiaries, or among a group of multiple beneficiaries), you can "roll away some of the stones" (i.e., the older beneficiaries or the non-individual beneficiaries) so that (when the final deadline, December 31 of the year after the year of death, rolls around) only the "good" beneficiaries are left. This can be done, e.g., by having the older beneficiaries disclaim, or by totally distributing the benefits of the older or non-individual beneficiaries.

Post-mortem planning now becomes more significant than it was before. Beneficiaries of a deceased employee or IRA owner will have until December 31 of the year after the year of death to "finalize" the decedent's choice of beneficiary for purposes of determining required distributions, through disclaimers or distributions or possibly other means. The rest of this section looks at various possible ways to improve the beneficiary designation post mortem, including both methods the IRS specifically blesses in the new proposed regulations and other methods as to which the IRS did not provide specific guidance one way or the other.

Changing the designated beneficiary by disclaimer

The new proposed regulations specify that disclaimers are given effect in determining who is the designated beneficiary. This result was in doubt under the old proposed regulations (see discussion at pages 308 *et seq.* of *Life and Death Planning for Retirement Benefits*). Thus, an older beneficiary (such as a surviving spouse or child) can disclaim the benefits and allow them to pass to a younger contingent beneficiary (such as a child or grandchild) and the younger beneficiary will then be "the" designated beneficiary whose life expectancy becomes the Applicable Distribution Period. P.R. § 1.401(a)(9)-4, A-4(a); Preamble, "Determination of the designated beneficiary." Incidentally, both of the proposed regulations' references use the term "disclaimers" rather than "qualified disclaimers," for what that's worth.

Establishing separate accounts after death

The IRS's multiple beneficiary rule specifies that, where there is more than one beneficiary, the participant is deemed to have "no designated beneficiary" unless all of the beneficiaries are individuals; and, if all the beneficiaries are individuals, all of them must use the oldest beneficiary's life expectancy to calculate required distributions. However, if the amounts passing to the various beneficiaries constitute "separate accounts payable to different beneficiaries," then the minimum distribution rules are applied separately to each such separate account. A separate account passing to a non-individual will not disqualify a separate account passing to only individual beneficiaries. The beneficiary of each separate account can use his or her own life expectancy to determined his or her own MRDs.

The definition of separate accounts has not changed from the prior edition of the proposed regulations. P.R. § 1.401(a)(9)-8, A-2 and A-3. For full discussion of the definition, and sample language that can be used in a beneficiary designation form to create "separate accounts" within a single IRA, see the author's article "How to Create Separate Accounts Within a Single IRA for Purposes of the Minimum Distribution Rules," Trusts & Estates, Vol. 139, No. 9, page 38 (September 2000).

What *has* changed is the date by which such separate accounts must be established. Under the old rules, the "applicable date" was the date of death (or the RBD, if earlier). Under the new rule, the applicable date (at least, in the case of death before the RBD; see "*Anomalies: separate accounts in case of death after RBD*," above, for possible problem in case of death on or after the RBD) is the Designation Date (end of the year following the year of death), meaning that (if the participant died before his RBD—and probably even if he died after it) a plan left to multiple beneficiaries can be divided into separate accounts for them after the participant's death. If the separate accounts are established by the Designation Date, then each separate account stands on its own for purposes of determining required distributions to the beneficiary of that account.

This is helpful not only for assuring that the existence of charitable beneficiaries does not prevent individual beneficiaries from using the life expectancy payout method, and not only for assuring that each designated individual beneficiary can use his or her own life expectancy (rather than the life expectancy of the oldest beneficiary) to measure required distributions, but also for applying the special spousal rules. See "Special Rules for the Surviving Spouse," below. The new flexibility to establish separate accounts after the participant has died does not mean that the multiple beneficiary problem should be ignored in estate planning for IRA owners. Including separate account language (similar to that suggested for pre-RBD planning in the author's article cited above) in the beneficiary designation form assures that separate account treatment will be recognized regardless of whether the beneficiaries manage to accomplish some physical division of the account prior to the Designation Date.

Eliminating beneficiaries by distributing their benefits

Another way to cure the multiple beneficiary problem is to distribution to any non-individual (or older) beneficiaries the shares payable to them. If the amounts payable to the non-individual (or older) beneficiaries are entirely distributed to them by the Designation Date, then only the remaining (younger, individual) beneficiaries who still have an interest in the benefit will "count" for purposes of determining who is the designated beneficiary. This could be most helpful if the separate account procedure is not available.

Example: Frank's beneficiary designation for his $1 million IRA reads "I leave $10,000 to Charity X and the rest of my IRA to my son." Under the old rules, Frank's son would probably not be able to use the life expectancy payout method, because of the multiple beneficiary rule. Now, if the charity's share is paid out by the Designation Date, the son is left as the sole designated beneficiary and the multiple beneficiary rule does not apply. Minimum required distributions will be determined based on the son's life expectancy.

Example: Deslin dies in 2002, after her required beginning date, leaving her IRA in equal shares to her husband and her granddaughter. They were her beneficiaries on her required beginning date back in 1997, but she had not established "separate accounts" for them on her required beginning date. Thus, under the old rules, both of her beneficiaries would have been stuck with using the rest of the joint life expectancy of Deslin and her husband (because the husband was the oldest beneficiary on the RBD) to measure required distributions. Under the new rules, if the husband's share is totally distributed out to him prior to December 31, 2003, the granddaughter becomes the sole designated beneficiary of Deslin's IRA on the Designation Date and her life expectancy will be used to measure her required distributions. The husband can roll over the portion paid to him to his own IRA and perhaps get even more deferral that way.

Distributing the account itself out of an estate

The IRS states emphatically, twice, that an estate cannot be a "designated beneficiary." P.R. § 1.401(a)(9)-4, A-3(a) and -8, A-11. What is not clear under the new proposed regulations is whether this problem can be cured by distributing the retirement plan itself (intact) out of the estate to the individual beneficiaries of the estate before the Designation Date.

Example: Jane dies without having named a beneficiary for her $1 million IRA. Under the terms of the IRA agreement, the IRA is payable to her estate in this case, so she does not have a "designated beneficiary" at the time of death. The only beneficiaries of her estate are her children Gray and Seymour. Before the Designation Date, the executor of her estate (before taking any distributions from the IRA) transfers the IRA account to Gray and Seymour. This transfer does not trigger any income tax, because it is an assignment of the right-to-receive-IRD to the persons entitled to receive the IRD under the decedent's will. § 691(a)(2), Reg. § 1.691(a)-4(b)(2). If we look at the situation on the Designation Date, it appears the children are now "the beneficiaries," and since they are individuals they qualify as "designated beneficiaries" and can use the life expectancy payout method.

The proposed regulations do not discuss this situation specifically. However, the broad statements of intent in the Preamble indicate that the specific examples in the new proposed regulations are not intended to be the only ways the identity of the designated beneficiary can be modified. For example: the change "allows...the beneficiary to be changed after the employee's death, *such as* [sic] by one or more beneficiaries disclaiming or being cashed out" ("Overview") (emphasis added), and "any beneficiary eliminated by distribution of the benefit or through disclaimer (*or otherwise*) during the period between the employee's death and the end of the year following the year of death is disregarded..." ("Determination of the designated beneficiary") (emphasis added).

On the other hand, as Mike Jones has pointed out, the Proposed Regulations' definition of designated beneficiary is "an individual who is designated as a beneficiary *under the plan*..." The individual must be "identifiable *under the plan* as of the" Designation Date. "The fact that an employee's interest under the plan passes to a certain individual under applicable state law does not make that individual a designated beneficiary unless the individual is designated as a beneficiary *under the plan*." P.R. § 1.401(a)(9)-4, A-1 (emphasis added). This language suggests that the residuary beneficiaries of an estate could not be "designated beneficiaries" if the benefits are payable merely to the "estate"of the deceased participant unless the plan itself so provides.

Powers of appointment

What if the participant's beneficiary designation form simply says "my benefits shall be distributed to such person or persons (including any charity) as my executor shall designate by written notice delivered to the plan administrator prior to the end of the calendar year after the year of my death?" Under the *old* rules, this approach clearly did not work, because it would not be possible at the applicable date (date of participant's death or required beginning date, whichever came first) to identify the oldest member of the class of potential beneficiaries (and also because non-individual beneficiaries are included in the mix).

Under the new rules, however, if the executor exercises his power of appointment irrevocably prior to the Designation Date, these objections could be removed. The executor, for example, could appoint the benefits to the participant's grandchildren, so that by the Designation Date the only beneficiaries of the retirement plan are these identifiable young individual beneficiaries. Does this work?

The language and examples in the regulations specifically discuss only eliminating beneficiaries chosen by the participant (by disclaimer or distribution), as opposed to adding new beneficiaries or simply choosing beneficiaries at random from a huge amorphous class, but then again as noted the proposed regulations also say that the examples provided are not intended to be exclusive. Furthermore, P.R. § 1.401(a)(9)-5, A-7(d)(1) provides that an employee is deemed to have "no designated beneficiary" if the plan permits any person to "have the discretion to change the beneficiaries of the employee" "*after the end of the calendar year following the calendar year in which the employee died*" (emphasis added). This wording implies that granting someone the power to change the employee's beneficiaries *prior* to the Designation Date is not a problem.

Some practitioners have pointed out that P.R. § 1.401(a)(9)-4, A-1, provides that "An individual may be designated as a beneficiary under the plan either by the terms of the plan or, if the plan so provides, by an affirmative election by the employee *(or the employee's surviving spouse)* specifying the beneficiary," and that § 1.401(a)(9)-4, Q-2, asks "Must an employee (*or the employee's spouse)* make an affirmative election specifying a beneficiary for a person to be a designated beneficiary?" (Emphasis added.) These practitioners have suggested that perhaps the parenthetical references to the employee's spouse's designating a beneficiary are intended to allow a surviving spouse (but not other beneficiaries or fiduciaries) to exercise a broad power of appointment during the post-death clean-up period. However, these references to a designation by the employee's spouse were carried over verbatim from the old proposed regulations (see Old P.R. § 1.401(a)(9)-1, D-1 and D-2). Probably the phrase is merely referring to the "(B)(iv)(II) Rule" situation (designated beneficiary is determined as of the surviving spouse's death, if the participant died before his required beginning date leaving the benefits to the surviving spouse as sole beneficiary and she then died before the required commencement of distributions to her) (see "*Rules apply 'as if' spouse were the participant: the '(B)(iv)(II) Rule'*," below).

Effect of beneficiary's death prior to Designation Date

A major problem under the new proposed regulations is, what happens if the original beneficiary survives the participant but then dies prior to the Designation Date.

The problem is that, as the proposed regulations are now written, the death of the primary beneficiary after the participant's death but prior to the Designation Date causes him or her to lose his or her status as "designated beneficiary." The participant's beneficiary will then be whoever happens to succeed to the interest of the primary beneficiary at that point.

If the plan permits the original beneficiary to name his own beneficiary (see "*Beneficiary's beneficiary*," below) (a successor beneficiary, if you will), *and* the beneficiary actually got around to doing that before he died, *and* the successor beneficiary is an individual who then does manage to survive until the Designation Date, then the successor beneficiary becomes "the" designated beneficiary of the participant, and the successor beneficiary's life expectancy is used to measure MRDs.

However, in many (maybe most) cases, either the plan does not permit beneficiaries to name successor beneficiaries, or the plan permits it but the beneficiary dies without doing so. In this case, the "successor beneficiary" is likely to be the primary beneficiary's *estate*...meaning that all of a sudden the participant has "no designated beneficiary," because an estate is not an individual. P.R. § 1.401(a)(9)-4, A-4(a). Perhaps the IRS will respond to comments requesting that the beneficiary's survival until the Designation Date not be required as a condition of "designated beneficiary" status; but if the rule stays as it is in the new proposed regulations, what steps can practitioners take in drafting beneficiary designation forms to head off this problem?

If the original beneficiary dies simultaneously with, or shortly after, the participant, the problem can be avoided by including standard simultaneous death or requirement-of-survival clauses in the beneficiary designation form. For example, the participant's beneficiary designation can specify that, in case of simultaneous deaths of the participant and primary beneficiary, the contingent beneficiary takes the benefits; or that any named beneficiary must survive the participant by some period of time (such as 30 days) to be entitled to the benefits.

However, this approach cannot eliminate the problem. For one thing, in order for a bequest to the surviving spouse to qualify for the estate tax marital deduction, it cannot be subject to a survivorship period requirement longer than six months. § 2056(b)(3). A requirement that the surviving spouse survive until the Designation Date would cause the gift to the spouse not to qualify for the marital deduction for the participant's estate, even if the spouse does in fact survive that long. Even if marital deduction qualification is not of concern (for example, if the beneficiaries are the participant's children rather than the spouse), it creates hardships on the beneficiaries to require them to survive until the Designation Date to be entitled to any benefits. They might need the money sooner—to pay estate taxes for example.

One solution is for the original participant to provide for an individual default beneficiary to take the benefits if the original beneficiary, having survived the participant, dies before taking out the benefits and without having named his own successor beneficiaries. In the author's experience, at least some IRA providers will not allow participants to do this, although there should be no objection to it if the IRA is in the form of a trust rather than a custodial account.

Special Rules for the Surviving Spouse

Overview of special spousal rules

In the area of retirement benefits, the Internal Revenue Code provides various special rules for a surviving spouse who inherits a deceased participant's benefits. Unfortunately, when the IRS sits down to translate Congress's statements into regulations, these special spousal "deals" inevitably have the effect of complicating the rules. Some complications (such as the availability of the spousal rollover) are "worth it" in the sense that they provide a substantial benefit to widows and widowers of deceased participants. Others (such as the different rules that apply to a spouse-beneficiary depending on whether the participant died before or after his required beginning date) appear to add substantial complication without much benefit.

There are four special provisions that may apply when the participant's surviving spouse is named as beneficiary:

A. The calculation of lifetime required distributions using Table VI rather than the Uniform Table, if the participant's beneficiary is his much-younger spouse; see "*Lifetime distributions if DB is much younger spouse*," above, for full discussion of this rule;

B. Use of the special recalc/fixed-term combo method for calculating the surviving spouse's life expectancy; see "*How to compute life expectancy of surviving spouse*," above, for full discussion of this rule.

C. The postponed commencement date for required distributions (and related rules) when the participant dies before his required beginning date leaving benefits to his surviving spouse; see "*Postponed commencement of MRDs: the (B)(iv)(I) Rule*" and "*Rules apply as if spouse were participant: the (B)(iv)(II) Rule*," in this section, below; and

D. The surviving spouse's right to roll over, to her own IRA, benefits inherited from a deceased spouse (or treat an IRA inherited from a deceased spouse as her own IRA); see "*Spousal rollovers: distributions from qualified plans*," "*Spousal rollovers: distributions from IRAs*," "*Election to treat an inherited IRA as the spouse's own IRA*," and "*Spousal rollovers and elections: is there a deadline?*" in this section, below.

All of these special rules are applicable if the participant's surviving spouse, *individually*, is the *sole* beneficiary of the participant's benefits. For what this means see "*What 'spouse is sole beneficiary' means*," below. After discussing that definition, this section next describes in detail the special spousal rules ((B)(iv) rules and spousal rollovers) that have not already been described in preceding sections of this outline. Finally, this section describes what happens under all four of the special spousal rules if, rather than being the sole outright beneficiary of the benefits, the surviving spouse individually is one of several beneficiaries.

What "spouse is sole beneficiary" means

The new proposed regulations define "spouse" as an "individual treated as the employee's spouse under applicable state law." P.R. § 1.401(a)(9)-8, A-5.

The spouse is "sole beneficiary" if she, alone, will inherit all of the benefits if she survives the participant; in other words she is the sole *primary* beneficiary. The fact that other beneficiaries are named as *contingent* beneficiaries (who will take if the spouse does not survive the participant, or does not survive him for some specified period of time) does not impair her status as "sole" beneficiary.

Example 1: The decedent's beneficiary form provides: "I name my spouse, Mrs. Participant, as my sole primary beneficiary, to receive 100% of all benefits payable under this Plan on account of my death if she survives me by 30 days; or, if she does not survive me by 30 days, the benefits shall be paid to sister Gladys." The spouse, Mrs. Participant, is the participant's sole beneficiary so long as both spouses are alive, and at his death if she survives him by 30 days and does not disclaim the benefits.

Example 2: The participant has never named any beneficiary. The retirement plan provides that, if no other beneficiary has been named by the participant, the benefits will be paid upon the participant's death to the participant's surviving spouse, if any, otherwise to the participant's estate. The spouse is the sole beneficiary as long as this situation (both spouses living, participant names no other beneficiary, plan provision remains as described) continues. She is the participant's sole beneficiary at his death if she survives him.

Exactly *when* the spouse must be "sole beneficiary" for various provisions to apply depends on the provision in question. In order for the participant to use Table VI instead of the Uniform Table for his lifetime MRDs in any particular distribution year, the spouse must be his sole beneficiary for the *entire distribution year*; see "*Lifetime distributions if DB is much younger spouse*," above. In order for the special method of determining the surviving spouse's life expectancy (see "*How to compute life expectancy of surviving spouse*," above) and the "(B)(iv) Rules" (see the next two subsections) to apply, the spouse must be the sole designated beneficiary *as of the Designation Date*. For a spousal rollover (or election) to be available, see discussions of those topics below.

Postponed commencement of MRDs: the (B)(iv)(I) Rule

If the participant dies prior to his required beginning date ("RBD") (see § 401(a)(9)(C) and P.R. § 1.401(a)(9)-2, A-2, for definition), the minimum distribution rules generally require that his benefits be distributed within five years after his death. This is called the "5-year rule." § 401(a)(9)(B)(ii); P.R. § 1.401(a)(9)-3, A-2. However, if the participant's benefits are left to a "designated beneficiary" (see § 401(a)(9)(E) and P.R. § 1.401(a)(9)-4, A-1, for definition), an exception to the 5-year rule is available: the benefits can, instead, be distributed in annual instalments over the life expectancy of the designated beneficiary. Normally, these annual distributions must begin by the end of the year following the year in which the participant died. § 401(a)(9)(B)(iii); P.R. § 1.401(a)(9)-3, A-3(a).

However, if the *sole* designated beneficiary of the participant is the participant's surviving spouse, instead of commencing in the calendar year following the year in which the participant died, the annual distributions to the spouse over her life expectancy must commence by the end of the *later* of: the year following the year in which the participant died; or the year in which the participant would have reached age 70½. § 401(a)(9)(B)(iv)(I); P.R. § 1.401(a)(9)-3, A-3(b).

Although this "(B)(iv)(I) rule" theoretically applies whenever the participant dies before his RBD, in fact it has an effect (under the new proposed regulations) only if the participant died before January 1 of the year in which he would have reached age 69½. This is so because if the participant dies in the year he reached (or would have reached) age 69½, or any later year, his "Designation Date" (December 31 of the year after the year he died) is the same as the required commencement date under the (B)(iv)(I) rule. If the spouse survives the participant but dies before that date, she is not his "designated beneficiary" on the Designation Date, so the (B)(iv)(I) rule does not apply. If she lives to that date, she is his "designated beneficiary" on the Designation Date, and she must commence distributions on that date, so the (B)(iv)(I) rule does not provide any later date of commencement of benefits. The normal "(B)(iii) rule" that applies to non-spouse beneficiaries (distributions must commence by December 31 of the calendar year following the year in which participant died) will produce exactly the same commencement date as the other choice available under the "(B)(iv)(I) rule" (distributions must commence by December 31 of the calendar year in which participant would have reached age 70½).

Therefore, in terms of its practical *desirable* effect of postponing the commencement of required distributions, the "(B)(iv)(I) rule" could be stated as follows: If the participant dies before the year in which he would have reached age 69½, and his sole designated beneficiary is his surviving spouse, the surviving spouse must take distribution of the benefits *either* entirely by the end of the year that contains the fifth anniversary of the participant's death *or* (beginning no later than December 31 of the year the participant would have reached age 70½) in annual instalments over her life expectancy.

Rules apply as if spouse were participant: the (B)(iv)(II) Rule

Now we come to the murkier side of § 401(a)(9)(B)(iv). § 401(a)(9)(B)(ii) and § 401(a)(9)(B)(iv)(I) read together provide that, "if an employee dies before the distribution of the employee's interest has begun in accordance with subparagraph (A)(ii)" [this is interpreted by the IRS in its regulations to mean "if a participant dies before his required beginning date"; see P.R. § 1.401(a)(9)-3, A-1], and the designated beneficiary is the participant's surviving spouse, then distributions can be made over the surviving spouse's life expectancy; and the IRS can by regulations permit a later commencement date for required distributions to the surviving spouse (later than the required commencement date applicable to non-spouse designated beneficiaries), provided such date "shall not be *earlier* than the date on which the employee would have attained age 70½" (emphasis added).

The IRS has in fact selected a required commencement date for distributions to the surviving spouse which is *later* than the date on which the employee would have attained age 70½, namely, December 31 of the year in which the employee would have attained age 70½. P.R. § 1.401(a)(9)-3, A-3(b).

The "(B)(iv)(II) Rule" then provides that: "if the surviving spouse dies before the distributions to such spouse begin [this is interpreted by the IRS in its regulations as "before the required commencement date for life expectancy distributions to such spouse"—see P.R. 1.401(a)(9)-3, A-5], this subparagraph [i.e., § 401(a)(9)(B)(iii), the exceptions to the 5-year rule—and the 5-year rule itself] shall be applied as if the surviving spouse were the employee." P.R. § 1.401(a)(9)-4, A-4(b).

In other words, if (1) the participant died before his RBD, leaving all the benefits to his surviving spouse and (2) the surviving spouse dies before the later of the end of the year after the year in which the participant died or the end of the year in which the participant would have reached age 70½, then distributions after the surviving spouse's death will not be based on continuing the life expectancy or other payout format of the original participant's benefits that applied or would have applied to the surviving spouse while she was alive. Rather, a new distribution period is installed: benefits must be distributed either by the end of the year that contains the fifth anniversary of the *surviving spouse's death* or (if the benefits are payable to a designated beneficiary *of the surviving spouse*) in annual instalments over the life expectancy of the *surviving spouse's* designated beneficiary, commencing no later than December 31 of the year following the year in which *the surviving spouse* died.

The "designated beneficiary" to whom the benefits are paid on the death of the surviving spouse could be an individual named as beneficiary by the surviving spouse (see P.R. § 1.401(a)(9)-4, A-1 and A-2). However, even if the surviving spouse remarried after the death of the original participant and left the benefits to her new surviving spouse, the "(B)(iv) Rules" are not re-activated; the newlywed surviving spouse of the now-deceased original surviving spouse takes as any other (non-spouse) designated beneficiary for purposes of the minimum distribution rules. P.R. § 1.401(a)(9)-3, A-5 (last sentence).

Like the (B)(iv)(I) Rule (discussed in the preceding subsection of this outline) the (B)(iv)(II) Rule cannot apply unless the participant died before the year in which he would have reached age 69½. If the participant dies in the year he attains (or would have attained) age 69½, or any later year, then the Designation Date is the same as the date of commencement of required distributions to the spouse-beneficiary. Therefore, even if the participant had a post-70½ RBD (for example, in the case of a Roth IRA which has no lifetime RBD, or in the case of certain retirement plans if the participant was still working after age 70½) it is impossible for the spouse to be the "designated beneficiary" for purposes of the (B)(iv) rules unless she is alive on the date distributions are required to begin (because that date is the same as the Designation Date). And if she is alive on the date distributions are required to begin the (B)(iv)(II) Rule does not apply.

However, the (B)(iv)(II) Rule can make a substantial difference if the participant died before the year in which he would have reached age 69½. The sequence under the (B)(iv)(II) Rule in that case is as follows:

Step 1: Participant dies before the year in which he would have reached age 69½. His surviving spouse, individually, is sole designated beneficiary on the Designation Date.

Step 2: Surviving spouse must either take distribution of all the benefits by the end of the year that contains the fifth anniversary of the participant's death; or must commence taking distributions over her life expectancy no later than December 31 of the year the deceased original participant would have reached age 70½. P.R. § 1.401(a)(9)-5, A-3(b). If she is using the life expectancy method, she takes distributions over her life expectancy, recalculated annually. Her life expectancy is determined using the single life expectancy table and based on her age on her birthday in the year for which a distribution is required. P.R. § 1.401(a)(9)-5, A-5(c)(2) (first sentence).

Step 3A: If the surviving spouse dies *before* her required commencement date specified in Step 2, then the benefits must be distributed either (i) entirely by the end of the year that contains the fifth anniversary of the *surviving spouse's death* or (ii) (if the benefits are payable to another designated beneficiary) in annual instalments over the life expectancy of the designated beneficiary, commencing no later than December 31 of the year following the year in which *the surviving spouse* died. The identity of the spouse's designated beneficiary is determined as of the "last day of the calendar year following the calendar year of surviving spouse's death." P.R. § 1.401(a)(9)-4, A-4(b). The spouse's designated beneficiary's life expectancy is determined starting with such beneficiary's single life expectancy as of his or her age as of his or her birthday in the year *after* the year in which the surviving spouse died. P.R. § 1.401(a)(9)–3, A-5 and A-6; -5, A-5(c)(1).

Step 3B: If the surviving spouse dies *after* her required commencement date specified in Step 2, then the remaining benefits must be distributed over the remaining fixed-term life expectancy of the surviving spouse determined in a special way. First, determine her single life expectancy as of her birthday in the year of her death. This life expectancy is used as the divisor for the year *following* the year of her death. The divisor for subsequent years is the same life expectancy, reduced by one year for each such subsequent year. P.R. § 1.401(a)(9)-5, A-5(c)(2) (second and third sentences).

Spousal rollovers: distributions from qualified plans

§ 402(c)(9) permits a surviving spouse, as beneficiary of a deceased employee, to roll over tax-free to an IRA "any distribution attributable to" the deceased employee that is paid to the spouse after the employee's death from a qualified retirement plan. Thus, if the surviving spouse is the sole beneficiary of the deceased participant, she can roll over any part or all of the amounts distributed to her as beneficiary, exactly to the same extent the participant could have rolled over the same amount had it been distributed to him during his lifetime, with one exception: the surviving spouse can roll over only into an IRA, whereas the participant would have had a broader choice of "eligible retirement plans" he could have rolled a distribution into.

The fact that a surviving spouse can roll over to the same extent the deceased participant could have done means that the same limitations that applied to the participant also apply to the surviving spouse (cannot roll over a minimum required distribution, cannot rollover a payment that is part of a series of equal payments, etc.; see § 402 and Chapter 2 of *Life and Death Planning for Retirement Benefits* for details).

Spousal rollovers: distributions from IRAs

The rollover of distributions from an inherited IRA is more complicated. § 408(d)(1) provides that IRA distributions are generally taxable. Then § 408(d)(3)(A) provides that the general rule does not apply (i.e., the distribution will *not* be taxable) if the entire amount of the distribution is rolled over to another IRA in a manner that meets various requirements. § 408(d)(3)(D) extends the non-taxability rule to qualifying partial rollovers.

However, § 408(d)(3)(C)(i) says that the non-taxability exception for rollovers is not available for a distribution from an "inherited IRA." § 408(d)(3)(C)(ii) then provides that an IRA "shall be treated as inherited if—

"(I) the individual for whose benefit the account or annuity is maintained acquired such account by reason of the death of another individual, and

"(II) such individual was not the surviving spouse of such other individual."

Here's what is tricky about this section. There are two different ways in which a surviving spouse can transfer IRA benefits she inherits from the deceased spouse to an IRA in her own name. One way is to take a distribution of benefits from the decedent's IRA and then re-contribute that distribution to another IRA that is in her own name. The other way is to elect to treat the decedent's IRA as the spouse's own IRA.

The election method is not discussed in the Internal Revenue Code; it is a creation of the IRS. The election method is discussed below, under "*Election to treat an inherited IRA as the spouse's own IRA*." The election method has its own set of complicated rules, including the rule that the surviving spouse must be the *sole* beneficiary of the decedent's IRA in order to make this election.

The distribution-followed-by-recontribution method is not as complicated. It comes out of the Code itself, as opposed to being a creation of the IRS regulations. Although the Code *could* be read as requiring that the surviving spouse must be the sole beneficiary of the deceased participant's IRA in order to avoid the dreaded "inherited IRA" status (because it refers to "the individual" for whose benefit the inherited account was maintained, not "one of the individuals"), there is no reason to read it so harshly. It can be read as meaning that a distribution from a decedent's IRA *to a surviving spouse* as beneficiary can be rolled over by her tax-free to her own IRA, while distributions from a decedent's IRA to *other* beneficiaries cannot be rolled over.

Election to treat an inherited IRA as the spouse's own IRA

A surviving spouse may elect to treat an IRA inherited from the deceased spouse as her own IRA if the following requirements are met: "the spouse must be the sole beneficiary of the IRA and have an unlimited right to withdrawal [sic] amounts from the IRA." P.R. § 408-8, A-5(a).

The requirement that the spouse must be the "sole" beneficiary to make this election has caused some consternation. However, this should not be an obstacle. For one thing, if the surviving spouse is not the sole beneficiary of the account, how could she elect to treat the account as her own? If part of the account belongs to other beneficiaries, she can hardly elect to treat their shares as her own IRA. But this problem is easily avoided by having her take a distribution of the portion payable to her and rolling it over to an IRA in her own name; or by having the multiple beneficiaries, prior to the Designation Date, transfer their respective shares of the inherited IRAs into multiple separate inherited IRAs, still in the name of the decedent, one payable to each of the multiple beneficiaries, and then the spouse *is* the sole beneficiary of the separate "inherited IRA" payable to her and can elect to treat it as her own.

The surviving spouse's election to treat an IRA inherited from the deceased spouse as her own IRA may be made "at any time after the distribution of the required minimum amount for the account for the calendar year containing the individual's date of death." P.R. § 408-8, A-5(a). This refers to the required minimum distribution attributable to the deceased participant for the year of his death, not to a required distribution to the spouse (since the account cannot generate minimum distributions attributable to the spouse until after she has made the election; P.R. § 408-8, A-5(a) (fifth sentence) and (c)).

Note that the statement refers only to the MRD for the year of death. What if the surviving spouse does not make the election in the year of death, but waits until the following year? Now under normal MRD principles another required distribution is due. Does she have to take that second year's distribution before she can elect to treat the account as her own? The answer to this question is not clear to the author. If she takes no required distribution as beneficiary, then she is deemed to have elected to treat the account as her own (P.R. § 408-8, A-5(b)(1)). But if she herself is already past age 70½ then she will be in default as a result of such a deemed election unless she takes a MRD on her own account. If she takes a distribution, how do we know whether the distribution was taken as beneficiary of the decedent or as IRA owner?

Another sentence in P.R. § 408-8, A-5(a) has the author buffaloed: "The required minimum distribution for the year of the election and each subsequent year would be determined under § 401(a)(9)(A) with the spouse as IRA owner and not section 401(a)(9)(B)." If the election occurs in the same year as the participant's death, this sentence would seem to indicate that there are two required distributions for the year of death (if both spouses are over 70½)—the decedent's (which must be distributed prior to the spouse's election) and the spouse's. This sentence seems to contradict the general rule that events such as death and contributions to the plan have no effect on MRDs until the year *following* the event. This sentence definitely needs clarification.

A surviving spouse may elect to treat an inherited IRA as her own IRA by contributing to the IRA or by failing to take the required minimum distribution for a year under section 401(a)(9)(B) as a beneficiary of the IRA, or by re-designating the account as her own IRA. P.R. § 408-8, A-5(b)

So here is the sequence regarding an IRA inherited by a surviving spouse as sole beneficiary:

Step 1: Participant dies in Year 1, leaving his IRA payable to his surviving spouse as sole beneficiary. If the deceased participant died on after April 1 of the year following the year in which he reached age 70½, the surviving spouse (or whoever succeeds to the account in Year 1 if the surviving spouse also dies, or disclaims the account, before the end of Year 1) must take any portion of the Year 1 MRD that the deceased participant failed to take prior to his death.

Step 2A: If the surviving spouse elects, in Year 1 (after taking any required distribution under Step 1), to treat the inherited IRA as her own, and she will not reach age 70½ until a later year, then this is the end of the story. The IRA is now hers, and she will have to start taking MRDs by April 1 following the year she reaches age 70½.

Step 2B: If the surviving spouse elects, in Year 1 (after taking any required distribution under Step 1), to treat the inherited IRA as her own, and she reaches age 70½ in Year 1 or reached it in an earlier year, it is not clear if she has an additional MRD to take (her own MRD, as opposed to the decedent's) for Year 1; see discussion above.

Step 3: If the surviving spouse did not elect, in Year 1, to treat the inherited IRA as her own, we come to Year 2. Assume the spouse does not die or otherwise cease to be the designated beneficiary of the IRA prior to the end of Year 2 (the Designation Date). The following outcomes are possible:

Step 3A: The participant died after the year in which he reached age 68½. In this case, in Year 2, the surviving spouse must take her first required distribution as designated beneficiary of the deceased, based on her single life expectancy, recalculated annually. If she fails to take (the entire amount of?) that distribution, she is deemed to have elected (effective January 1, Year 2?) to treat the account as her own. See discussion above, and Step 4.

Step 3B: The participant died before the year in which he would have reached age 69½. In this case, the "(B)(iv) Rules" apply; see discussion under that heading.

Step 4: Once the surviving spouse has elected to treat the IRA as her own, and she reaches her own RBD, then she must take a distribution from the account based on the Uniform Table (or, if she has remarried a much-younger spouse and named him as her sole designated beneficiary for the entire distribution year) based on the joint life expectancy of herself and her much-younger spouse.

The moral of the story is that a surviving spouse should probably take positive affirmative steps, documented in writing, as soon as possible to either elect to treat an inherited IRA as her own or to clarify that she intends to continue to hold it as beneficiary.

Spousal rollovers and elections: is there a deadline?

One question that has worried practitioners is whether the IRS intended to impose some kind of deadline on rollovers by the surviving spouse. The new proposed regulations suggest the contrary, at least in the case of the surviving spouse's ability to elect to treat an IRA inherited from the deceased spouse as her own. P.R. § 1.408-8, A-5 provides that "The surviving spouse of an individual may elect...to treat the spouse's entire interest as a beneficiary in an individual's IRA (*or the remaining part of such interest if distribution thereof has commenced to the spouse)* as the spouse's own IRA. This election is permitted to be made *at any time* after the distribution of the required minimum amount for the account for the calendar year containing the individual's date of death" (emphasis added).

The surviving spouse's right to elect to treat an IRA inherited from the deceased spouse as her own IRA is not a "minimum distribution rule"; it derives from § 408, not § 401(a)(9). Therefore rules dealing with this right do not depend on the spouse's surviving until the Designation Date. If the surviving spouse has made this election prior to the Designation Date, then the account as to which she made that election presumably drops out of the picture as far as calculating the original deceased participant's required distributions, and her death after the election (but prior to the original participant's Designation Date) does not cancel out her status as designated beneficiary for purposes of the election.

The spouse, individually, is one of multiple beneficiaries

Now that we have seen all the special rules that apply if the surviving spouse, individually, is the participant's *sole* beneficiary, we next look at what happens under all these special rules if the surviving spouse, individually, is *a* beneficiary, but is not the *sole* beneficiary. Examples: The participant's beneficiary form provides: "I name my spouse, Mrs. Participant, and my son Oscar Participant, as my sole primary beneficiaries, each of them to receive 50% of all benefits payable under this Plan on account of my death." Or, "Upon my death, the Account shall be distributed as follows: $5,000 shall be paid to the Salvation Army, and the balance shall be paid to my spouse, Mrs. Participant." Or, "An amount equal to my federal estate tax exemption shall be distributed in equal shares to such members of the class consisting of my children, Hughie, Dewey and Louis Participant, as shall survive me, and the balance of my benefits under this plan shall be paid to my spouse, Mrs. Participant."

A living participant must use the Uniform Table to calculate distributions unless his much-younger spouse is his *sole* beneficiary. Apparently, the individual's status as "spouse" and her status as "sole beneficiary" are both determined on an annual basis, so that, if the spouse is one of several beneficiaries in Year 1, but is sole beneficiary for all of Year 2, the participant can use Table VI for Year 2 but not for Year 1. P.R. § 1.401(a)(9)-5, A-4(b).

For purposes of the *post-death minimum distribution rules* it is not essential that the surviving spouse be the sole beneficiary at the time of the decedent's death, only that she be sole beneficiary on the Designation Date (end of the year following the date of the participant's death). Thus, in some cases, it will be possible to "remove" other beneficiaries (by means of disclaimer or distribution) so that the spouse can become the sole beneficiary by the Designation Date. Also, the minimum distribution rules are applied separately to "separate accounts" within a single plan or IRA, so if there are multiple beneficiaries of the decedent's plan, but their respective portions constitute "separate accounts" as of the Designation Date, then the "spouse-is-sole-beneficiary" minimum distribution rules will apply to a *separate account* of which the spouse is the sole beneficiary, even if there are other beneficiaries of other accounts.

If, after application of all of the above rules, the surviving spouse is *not* the sole beneficiary of the participant on the Designation Date, the postponed commencement date provided in § 401(a)(9)(B)(iv)(I) is not available (P.R. § 1.401(a)(9)-3, A-3) and the special rule of § 401(a)(9)(B)(iv)(II) (which applies the 5-year rule and its (B)(iii) exception as if the surviving spouse were the "employee") does not apply. P.R. § 1.401(a)(9)-3, A-5.

If, as of the Designation Date, the surviving spouse is not the sole beneficiary, but is the *oldest* beneficiary, her life expectancy is computed in the same fixed-term manner as that of any non-spouse designated beneficiary, in other words, under P.R. § 1.401(a)(9)-5, A-5(c)(1), not P.R. § 1.401(a)(9)-5, A-5(c)(2).

If the surviving spouse is not the sole beneficiary of an IRA, she cannot elect to treat the IRA as her own. See complete discussion above under "*Election to treat an inherited IRA as the spouse's own IRA*."

Other Changes and Clarifications Made By New Proposed Regs

Annuity payouts

"Due to the relatively small number of comments on practices with respect to annuity contracts, and the effect of the 1987 proposed regulations on these practices, the basic structure of the 1987 proposed regulation provisions with respect to annuity payments is retained" in the new proposed regulations. P.R., Preamble, "Background."

This outline deals with the rules for *non-annuity* payouts. This outline does not cover P.R. § 1.401(a)(9)-6 ("Required minimum distributions as annuity payments.") which contains the minimum distribution rules applicable to annuity distributions from a defined benefit plan.

Beneficiary's beneficiary

The new proposed regulations confirm (as stated on pages 61-62 of *Life and Death Planning for Retirement Benefits*) that, once the participant has died and the "Applicable Distribution Period" has been established based on the life expectancy of the participant's designated beneficiary, the subsequent death of the designated beneficiary prior to the end of the Applicable Distribution Period does not accelerate required distributions, which are still to continue over that fixed term life expectancy; P.R. § 1.401(a)(9)-5, A-7(c)(2) and (c)(3) (Example 1); and that allowing a beneficiary to "designate a subsequent beneficiary for distributions of any portion of the employee's benefit after the beneficiary dies" does not violate the rule that "no person may have the discretion to change the beneficiaries of the employee" after the employee's death. P.R. § 1.401(a)(9)-5, A-7(d).

Default rules change; automatic excise tax waiver

As explained above (see "The New Way to Determine Post-Death Distributions"), if a participant dies before his RBD, benefits must be paid out either under the 5-year rule or over the life expectancy of a designated beneficiary. A retirement plan can provide that its participants and/or their beneficiaries can irrevocably elect which method will apply, or can provide that one or the other method must be used in some or all situations; and if the plan permits participants and/or beneficiaries to choose, the plan can provide a default rule that will apply if the participant and beneficiary fail to elect a method. P.R. § 1.401(a)(9)-3, A-4(b), (c).

If the plan does not contain such optional provisions, the proposed regulations contain a default rule. Under the old proposed regulations, the default rule was the 5-year rule. The new proposed regulations provide that the default rule is the life expectancy of the designated beneficiary, if there *is* a designated beneficiary. P.R. § 1.401(a)(9)-1, A-3(c); -2, A-3(c); -3, A-4(a)(1). This is the default rule the author had recommended that IRA providers adopt, in "Required and Permitted Elections Under the Minimum Distribution Rules," NY State Bar Association Trusts and Estates Law Section Newsletter, Vol. 33, No. 3, p.4 (Fall 2000).

Under the new proposed regulations, the 5-year rule is the default rule only if there is no designated beneficiary as of the Designation Date. P.R. § 1.401(a)(9)-3, A-4(a)(2).

This change could cause someone to incur a penalty inadvertently: if there is a designated beneficiary, and he or she plans to use the 5-year rule rather than the life expectancy method; or if he or she for some other reason simply fails to take a required distribution in one of the first years after the date of death; the 50% penalty under § 4974(b) is incurred. The new proposed regulations overcome that problem *if there is only one individual beneficiary* by providing that the penalty is automatically waived if the participant's entire benefit is distributed by the end of the fifth calendar year following the calendar year the contains the participant's date of death. P.R. § 54.4974-2, A-8(b). It is not clear to this author why the IRS would limit this reasonable provision to the situation in which there is only one individual beneficiary. Why should it not apply whenever the 5-year rule is available?

Similarly, the Preamble ("Default rule for post-death distributions") provides that, in case of death before the RBD, there will be a waiver of the penalty for failing to take the MRD under the life expectancy method if the entire benefit is distributed by the end of the fifth year—"unless the Commissioner determines otherwise." Why would the Commissioner ever want to impose a penalty if the 5-year rule had been complied with?

Enforcement and reporting

Major news for IRA providers (and for MRD scofflaws): the new proposed regulations require IRA providers to report annually, not only the year-end account value of each IRA (as they already do), but also the amount of the minimum required distribution for the year in question. P.R. § 1.408-8, A-10. For example, if the reporting requirement is in effect for 2003, the IRA provider will have to report the 12/31/2003 balance, and will also have to report the 2003 required distribution (which is based on the 12/31/*2002* balance).

Since MRDs are determined under the Uniform Table for (almost) every living IRA owner, it will be easy for the IRA providers to calculate MRDs for their living customers. And it will then be easy for the IRS's computers to total up the MRDs for all of the taxpayer's IRAs and make sure he reports that much income on his tax return.

Since Notice 88-38 is not repealed (see P.R., Preamble), the participant does not have to take the MRD *for* each IRA *from* that IRA. He can take the distribution attributable to any IRA from that particular IRA or from any other IRA he holds as "owner," so long as the total IRA distributions he takes add up to the total amount of the MRD for each of the separate IRAs. The total amount of his distributions, from whatever IRA he takes them, should still add up to the same total MRD amount reported by all his IRA providers. (See "*Multiple plans or IRAs, distributions from*," below, for full details of this rule, including exactly which IRAs can be combined for purposes of Notice 88-38.)

The effective date for this new reporting requirement has not been established. P.R., Preamble, "IRA reporting of required minimum distributions." Perhaps that's just as well because, despite the simplified method of computing MRDs, there are still plenty of wrinkles to keep the IRA providers busy programming their computers to do these reports. For example:

1. If the IRA is still in existence even after it was supposed to be entirely distributed, the IRA provider just keeps reporting 100% of the account annually as the required minimum distribution. P.R. § 54.4974-2, A-5.

2. If the participant's sole beneficiary is his much-younger spouse, the IRA provider must consult an actual life expectancy table (Table VI) (as opposed to simply the Uniform Table).

3. For the first distribution year (the year the participant reaches age 70½), the IRA provider will dutifully report a MRD of 1/26.2 or 1/25.3 times the prior year-end account balance, but the participant doesn't actually have to take any of that until April 1 of the following year. Perhaps the IRS computers will be programmed to ignore these reports for the year the participant reaches age 70½.

4. For the second distribution year (the year the participant reaches age 71½), the prior year-end balance is calculated in a special way: it is the year-end account balance (i.e. the balance as of the end of the year the participant reached age 70½), minus the excess of the required distribution for the age 70½-year over the amount actually distributed in the age 70½-year. The IRA provider can compute this for its particular IRA, but has no way of knowing if the participant took his MRD attributable to this account for the age-70½-year from some *other* IRA, using Notice 88-38. (See "*Multiple plans or IRAs, distributions from*," below.) If the participant indeed took the MRD from a different account, then the prior year end account balance for *this* account should not be adjusted downwards to reflect undistributed MRDs. Perhaps the IRS computers will have to be programmed to ignore the IRA providers' reports for the year the participant reaches age 71½ as well as the year the participant reaches age 70½!

5. It is not clear whether the reporting requirement applies to inherited IRAs. The proposed reg says only that it applies to "IRA owners." P.R. § 1.408-8, A-10. This term is used generally in contrast to an IRA "beneficiary." See *e.g.*, P.R. § 1.408-8, A-5(b), discussing a surviving spouse's right to re-designate an account as an account in her name "as IRA owner rather than as beneficiary."

6. If an addition to the account represents a rollover from another plan or IRA, the IRA provider must determine whether it was distributed from such other plan or IRA in the prior calendar year ("Year 1"). If so, it is *deemed* to have been received in that prior calendar year (i.e., Year 1) for purposes of MRDs from the receiving plan for the year it was *actually* received (Year 2). Presumably this can only happen in the first 60 days of the calendar year, since distributions must be rolled over within 60 days of receipt. P.R. § 1.408-8, A-7.

Multiple plans or IRAs, distributions from

The new proposed regulations confirm IRS Notice 88-38 (1988-1 .C.B. 524) to the extent of providing that:

1. Qualified plans may not be aggregated for purposes of computing the participant's required distributions; the participant must take each plan's distribution from that plan. P.R. § 1.401(a)(9)-8, A-1.

2. An individual's IRAs may be aggregated with each other (and his 403(b) plans may be aggregated with each other) for purposes of determining his required distributions from all such IRAs (or all such 403(b) plans) collectively.

3. IRAs cannot be aggregated with 403(b) plans, distributions from a Roth IRA do not satisfy the distribution requirement for a traditional IRA or a 403(b) plan, and that distributions from a traditional IRA or a 403(b) plan do not satisfy the distribution requirement for a Roth IRA. P.R. § 1.408-8, A-9.

The proposed regulations modify Notice 88-38 (without mentioning that this is a modification) by providing that an individual's IRAs held as *owner* may not be aggregated with IRAs held as *beneficiary of another person* (P.R. § 1.408-8, A-9); that an individual's 403(b) plans held as *employee* may not be aggregated with such individual's 403(b) plans held as *beneficiary of another person* (P.R. § 1.403(b)-2, A-4); and that an individual's IRAs (or 403(b) plans) held as beneficiary of one decedent may not be aggregated with IRAs (or 403(b) plans) held as beneficiary of another decedent. P.R. § 1.408-8, A-9.

Permitted delays for QDROs or insurance company problems

Minimum distributions can be delayed in two situations: a review period for QDROs and (in the case of insured plans) delay caused by receivership of the insurance company. See § 1.401(a)(9)-8, A-7 and A-8. for details. See P.R. § 1.401(a)(9)-8, A-6 and A-7 generally for QDROs.

Required beginning date, definition of

For the first time, the proposed minimum distribution regulations update the definition of "required beginning date" to reflect the Small Business Job Protection Act of 1996. P.R. § 1.401(a)(9)-2, A-2(a) provides that the RBD for a non-5% owner in a QRP or 403(b) plan is *generally* "April 1 following the later of the calendar year in which the employee attains age 70½, or the calendar year in which the employee retires from employment with the employer maintaining the plan."

However, the new proposed regulations also provide that a qualified plan is not required to recognize the postponed RBD permitted by the Small Business Job Protection Act of 1996. Instead, a plan can choose to require *all* employees (even those who are not 5% owners) to commence distributions by April 1 following the year they reach age 70½. P.R. § 1.401(a)(9)-2, A-2(e); -8, A-9. If the plan *does* require all employees to commence distributions by April 1 following the year they reach age 70½, then (notwithstanding Code § 401(a)(9)(C)(i)) that date becomes the employee's required beginning date. An employee in such a plan is treated as dying "on or after his RBD" if he dies on or after April 1 following the year in which he reached age 70½, even if he owned less than 5% of the sponsoring employer and had not yet retired. P.R. § 1.401(a)(9)-8, A-9.

As under the old proposed regulations, distributions taken prior to the RBD have no bearing on the question of whether the participant died before or after his RBD. § 1.401(a)(9)-2, A-4; A-6(a).

The new rules still do not clarify several cloudy issues created by the Small Business Job Protection Act of 1996 discussed under the heading "The Required Beginning Date: When It Is" in Chapter 2 of *Life and Death Planning for Retirement Benefits*. For example, the proposed regulations still provide no definition of what constitutes "retirement."

Rollovers and plan-to-plan transfers

P.R. § 1.401(a)(9)-7 deals extensively with rollovers and plan-to-plan transfers. For the most part this material has little impact on estate planning and accordingly this outline does not exhaustively explore these rules.

In general, the new proposed regulations continue the earlier scheme. A rollover *into* a plan or IRA has no effect on MRDs *from* that plan or IRA until the next year.

Example: Joan, age 73, receives a distribution from the retirement plan of her deceased spouse, Philip, in 2000, and rolls it to a new IRA in her own name in 2000. Joan's first MRD from the rollover IRA will be in the following year, 2001. If Joan had rolled the distribution into her pre-existing IRA (from which she was already taking MRDs), it would have had no effect on the amount of her 2000 MRD; the rollover would become part of the 12/31/2000 balance, and therefore have the effect of increasing the 2001 MRD. P.R. § 1.401(a)(9)-7, A-2.

What's Unchanged; New Problems; New Opportunities

Minimum distribution rules not changed by the new proposed regs

The IRS does not plan to change the life expectancy tables in the near future. P.R., Preamble, "The uniform distribution period."

The importance of having a proper "designated beneficiary" has not changed (although greater flexibility to acquire one after the required beginning date and even after death has been added), and the definition of what constitutes a "good" designated beneficiary (for purposes of getting the longest tax deferral after death) has not changed: a surviving spouse who can do a rollover, younger generation individuals, trusts that comply with the trust rules.

Since the proposed minimum distribution regulations are completely restated by the new proposed regulations, everything is covered, even items that are not being changed, such as: the rules for determining who is the employee's "designated beneficiary" under the plan (P.R. § 1.401(a)(9)-4, A-1 and A-2); the fact that taking more than the required distribution in one year does not give the recipient a "credit" to reduce required distributions in subsequent years (P.R., Preamble, "The uniform distribution period"; § 1.401(a)(9)-5, A-2); method of determining the account balance (P.R. § 1.401(a)(9)-5, A-3); treatment of TEFRA 242(b) elections (P.R. § 1.401(a)(9)-8, A-13 through A-16); rollovers and plan-to-plan transfers (P.R. § 1.401(a)(9)-7); and the definition of separate accounts within a single plan (P.R. § 1.401(a)(9)-8, A-3).

Planning problems not affected by the new proposed regs

The new proposed regulations have no effect on estate tax issues. Thus the knotty problem of "how to use the client's estate tax exemption" (or GST exemption) when the client's primary or only asset is a retirement plan has not gone away. See the Allen Able case study in Chapter 11 of *Life and Death Planning for Retirement Benefits*. Various planning ideas for reducing the estate and income tax value of retirement benefits (for example, through life insurance, family partnerships, or adoption of a defined benefit plan) are not affected by the new proposed regulations. The problem of how to pay estate taxes on a substantial retirement plan balance has not gone away.

The drawbacks of funding a QTIP trust with retirement benefits are not affected by the new proposed regulations. See the Ken Koslow case study in Chapter 11 of *Life and Death Planning for Retirement Benefits*. Marital deduction requirements for retirement benefits are not affected, nor are spousal rights (under REACT), creditors' rights, or Medicaid qualification issues. The various aspects of holding life insurance in a retirement plan (see Chapter 10 of *Life and Death Planning for Retirement Benefits*) are not changed by the proposed regulations.

Lump sum distributions, 10 year averaging, pre-age 59 ½ distributions, net unrealized appreciation of company stock, and the special 20% max tax on pre-1974 benefits are not affected.

New problem: Designation Date same as distribution date

The fact that the date for *determining who is the designated beneficiary* (which determines the amount of the required distribution) is now also the deadline for *making the required distribution* will create such huge problems for plan administrators that the IRS will probably have to modify this approach.

Example: Bud dies in 2002 leaving his IRA to his three children, Flora, Dora and Laura. Flora disclaims her share and as a result her share passes to the contingent beneficiary, a trust for her children. The trustee drags his feet in supplying the required documentation to the IRA provider. The trustee and Dora want separate accounts established, but Laura won't go along with the idea because she doesn't like Dora. Finally, on December 30, 2003, the trustee (bringing the required documentation) and Laura (having finally signed the separate account agreement) come in to see the IRA provider, but say they can't find Dora anywhere. The IRA provider now has 24 hours to compute the separate accounts, review the trust documentation, calculate minimum required distributions to the trust and Laura, figure out whether Dora is dead (and if so calculate the required distribution to her estate) or alive (and if so calculate the MRD based on Dora's life expectancy), and cut three checks to make the distributions. Obviously, this won't work! Perhaps the IRS will allow a postponement of the first required distribution after death until April 1 after the Designation Date, or provide an automatic penalty waiver if the first distribution is made within a certain amount of time after the Designation Date.

New opportunity for beneficiaries of deceased participants

The new proposed regulations provide substantially increased income tax deferral opportunities for many individuals who are now taking required distributions from IRAs and other retirement plans they inherited from deceased participants—even for beneficiaries who inherited from decedents who died long ago, if the account is still in existence.

The proposed regulations "apply for purposes of determining required minimum distributions for calendar years beginning on or after January 1, 2002." P.R. § 1.401(a)(9)-1, A-2. Neither this statement of the effective date, nor the new rule regarding the date for determining who is the designated beneficiary of a deceased participant, makes any distinction based on whether the plan participant died before or after any particular date. Thus it appears that all individuals now receiving required distributions from inherited retirement plans, *regardless of how long ago the original participant died*, must switch to the new rules in 2002.

Although the proposed regulations do not specifically discuss the question of how the new rules affect beneficiaries of IRAs and other retirement plans inherited from deceased participants who died before the proposed regulations were issued, IRS Notice 1270 (February 2001) adds substantial clarification. This notice, which is a supplement to IRA Publication 590 (IRAs), indicates that all beneficiaries of inherited IRAs may use the new rules starting with the 2001 required distribution. There is no distinction between beneficiaries of IRA owners who died in 2000 and beneficiaries of IRA owners who died prior to 2000. Beneficiaries taking distributions from an inherited qualified retirement plan (as opposed to an inherited IRA) must wait until the plan is amended before they can start using the new rules.

For beneficiaries of a participant who died in the year 2000, the ability to use the new rules would mean that they would have until December 31, 2001, to finalize the decedent's beneficiary designation, and can take advantage of various post-mortem planning techniques. See "Identity of DB Determined at End of Year after Death," above.

Even where there is no need (through post-mortem planning) to change the identity of the beneficiary who inherits the benefits, the switch from basing the "applicable distribution period" for post-death distributions on the beneficiaries *as of the required beginning date* (under the old rules) to basing it on the beneficiaries *as of the end of the year after the year of death* will help many beneficiaries.

Example 1: On her required beginning date back in 1996, Pearl named her estate as her IRA beneficiary, and thus was deemed to have no "designated beneficiary." She started taking her distributions based on her single life expectancy (which was 15.3 years as of her first distribution year, 1995), not recalculated. She then died in 1999. By the time of her death, she had changed her beneficiary designation to her daughter, Ruby. Under the old rules, Ruby's MRD, as Pearl's beneficiary, for the year 2001 would be based on what was left of Pearl's single life expectancy, so Ruby would use a divisor of 9.3 (Pearl's original single life expectancy as of 1995, 15.3 years, minus 6 elapsed years). Under the *new* rules, since Ruby was Pearl's beneficiary at Pearl's death (and assuming she still is on the Designation Date), Ruby can switch over to using her own life expectancy. She determines that her life expectancy as of 2000 (the year after Pearl's death) was 31.3 years (because Ruby reached age 52 in 2000 and 31.3 years is the life expectancy from Table

V for age 52). So her 2001 required distribution will be the 2000 year-end account value divided by 30.3—an increase of 21 years of income tax deferral for her inherited IRA!

Example 2: On his required beginning date in 1995, Dan named his wife Trish as primary (designated) beneficiary of his IRA, and elected to redetermine both life expectancies annually. His children were named as contingent beneficiaries. He never changed his beneficiary designation. Trish died in 1999 and Dan died in 2000. The children inherited the IRA. Under the old rules, the children would have to withdraw 100% of the benefits by December 31, 2001 (the "one year rule"). Under the new rules, they can use the oldest child's life expectancy to measure the required distributions (or even use each child's individual life expectancy, if they establish "separate accounts" by the Designation Date), because the applicable date for determining who are the "designated beneficiaries" of this account for purposes of post-death required distributions has shifted from *Dan's RBD* (back in 1995, when the DB was Trish) to *the end of the year after the year of Dan's death* (by which time the children, not Trish, are the DBs).

Example 3: Rich died in 1998, prior to his required beginning date. He left his $1 million IRA payable "$1,000 to my church and the rest to my son Randy." Randy paid out the charity's $1,000 bequest in 1999, meaning that Randy was the sole beneficiary as of 12/31/99 (the applicable date for determining the designated beneficiary under the new rules). As suggested under "*Cleanup strategies—death before the RBD*," at page 20 of *Life and Death Planning for Retirement Benefits*, Randy took minimum distributions from the account based on his life expectancy for the years 1999 and 2000, waiting to see if maybe (under some future interpretation of the minimum distribution rules) he could escape the 5-year rule. Under the old rules, Rich was deemed to have no designated beneficiary because of the multiple beneficiary rule. Under the new rules, Randy meets the requirements for a life expectancy payout.

Comments By Type Of Plan

Qualified retirement plans: defined contribution

Qualified plans will have to be amended to reflect the new rules. A qualified plan may, but is not required to, implement the new rules prior to the effective date of final regulations (anticipated January 1, 2002), by adopting the model amendment in the new proposed regulations. The IRS will not issue determination, opinion, or advisory letters based on those changes until final regs are issued." P.R., Preamble, "Amendment of Qualified Plans."

The main problem that planners and clients have with qualified plans, namely, that most such plans do not offer the life expectancy method as a form of benefit, is not affected by the new rules. Many employees will continue to be stuck with the fact that their retirement plans offer only one form of death benefit (a lump sum distribution).

Qualified retirement plans: defined benefit

The Preamble ("Annuity payments") states that the IRS is continuing to study the questions of whether the defined contribution plan rules should apply to defined benefit plan benefits not distributed in the form of an annuity, and whether the "separate accounts" concept should be applicable to defined benefit plans. This outline does not cover defined benefit plans.

Roth IRAs

Like the old proposed regulations, the new proposed regulations are written primarily for qualified retirement plans, but the post-death distribution requirements are incorporated by reference into § 408A (governing Roth IRAs). § 408(a)(6), § 408A(c)(5). Since Roth IRAs do not and never did have a "lifetime" distribution requirement, the changes made by the new proposed regulations have a less dramatic impact on Roth IRAs than on other types of retirement plans. The only change that significantly affects Roth IRA distributions is the opportunity to "finalize" the identity of the death beneficiary any time up to the Designation Date.

The new rules should increase the number of individuals who qualify to convert to a Roth IRA. (The requirements for converting to a Roth IRA are not affected.) Since required distributions from qualified plans and (until 2005) IRAs are included in gross income, anything that has the effect of reducing a participant's required minimum distributions should increase the number of participants who will have gross income under $100,000. However, at least one planner has pointed out that the longer deferral now available to traditional IRAs decreases the relative advantages of converting to a Roth IRA.

There are some clients who converted to a Roth IRA in 2000 whose reason for converting to a Roth IRA was to escape the consequences of choices and elections they had made at the RBD. Since everyone now gets a fresh start, a client who converted his traditional IRA to a Roth for this reason in the year 2000 may want to consider undoing the conversion prior to the due date of his 2000 tax return. For an excellent explanation of exactly how to undo a Roth conversion, see the article "2000: Year of the Roth Recharacterization," in the February 2001 edition of Ed Slott's IRA Advisor newsletter (800-663-1340; or www.irahelp.com).

Traditional IRAs

Like the old proposed regulations, the new proposed regulations are written primarily for qualified retirement plans, but the requirements are incorporated by reference into § 408, the Code section governing IRAs. § 408(a)(6). P.R. § 1.408-8 provides details necessary to adapt the qualified plan rules for IRAs. The new proposed regulations close a gap that has existed in the old proposed regs for many years, namely, the question of who is the "plan administrator" of an IRA. The new proposed regulations provide that "the IRA trustee, custodian, or issuer is treated as the plan administrator." P.R. § 1.408-8, A-1(b).

IRA documents will eventually have to be amended to reflect the new rules. IRA sponsors are to wait before amending their documents until the IRS issues new model IRAs, which will not occur until the regulations are finalized. However, IRA "owners" don't have to wait until the IRA provider takes action to take advantage of the new rules. "IRA owners are permitted, but not required, to follow" the new proposed regulations "for the 2001 calendar year," regardless of whether the underlying documents are amended. P.R., Preamble, "Amendment of IRAs and Effective Date." IRA owners includes IRA beneficiaries; see IRS Notice 1270 and "*New opportunity for beneficiaries of deceased participants*," above.

Here's a stumper: can a participant who has more than one IRA elect to use the old rules for some accounts and the new rules for others for the year 2001? The proposed regulations do not discuss this.

For other changes regarding IRAs, see "*Multiple plans or IRAs, distributions from*" and "*Spouse, special rules for*," above.

403(b) plans

The minimum distribution requirements applicable to qualified plans are made applicable to 403(b) plans by § 403(b)(10). P.R. § 1.403(b)-2, A-1(a). The new proposed regulations acknowledge that the RBD for all 403(b) plans is the later of April 1 following the year the participant reaches age 70½ and April 1 following the year the participant retires; there is no possibility of a different rule for "5% owners" because all 403(b) plans are maintained by tax-exempt charitable organizations that have no "owners." P.R. § 1.403(b)-2, A-1(c)(1). It is not clear to the undersigned whether 403(b) plans are permitted (as qualified plans are) to impose April 1 following the age-70½-year as the RBD for all employees; compare P.R. § 1.401(a)(9)-2, A-2(e) with P.R. § 1.403(b)-2, A-1(c)(1).

The new proposed regulations confirm that a surviving spouse as beneficiary of a 403(b) plan cannot elect to treat an inherited 403(b) account as her own; that option applies only to inherited IRAs. P.R. § 1.403(b)-2, A-1(c)(2). The special grandfather rule for separately identified pre-1987 benefits is continued. P.R. § 1.403(b)-2, A-2 and A-3. See also "*Multiple plans or IRAs, distributions from*," above. The IRS is considering whether to apply the MRD reporting requirement to 403(b) plans. P.R., Preamble, "IRA reporting of required minimum distributions." In contrast to IRAs and QRPs, the new proposed regulations do not state whether 403(b) plan participants may begin using the new rules prior to the amendment of the underlying plan documents.

The “Uniform Table”

(Formerly known as the “MDIB Rule Divisor Table”)
...for determining lifetime required distributions for (almost) everyone

Table for Determining Applicable Divisor			
Age	**Applicable divisor**	**Age**	**Applicable divisor**
70	26.2	93	8.8
71	25.3	94	8.3
72	24.4	95	7.8
73	23.5	96	7.3
74	22.7	97	6.9
75	21.8	98	6.5
76	20.9	99	6.1
77	20.1	100	5.7
78	19.2	101	5.3
79	18.4	102	5.0
80	17.6	103	4.7
81	16.8	104	4.4
82	16.0	105	4.1
83	15.3	106	3.8
84	14.5	107	3.6
85	13.8	108	3.3
86	13.1	109	3.1
87	12.4	110	2.8
88	11.8	111	2.6
89	11.1	112	2.4
90	10.5	113	2.2
91	9.9	114	2.0
92	9.4	115 and older	1.8

The above Uniform Table may be used by all IRA owners who have reached age 70½ to determine their annual minimum required distributions (MRDs) for 2001 and 2002. For each “Distribution Year” (i.e., a year for which a distribution is required), determine: (A) the account balance as of the preceding calendar year end; (B) the participant’s age attained in the Distribution Year; and (C) the “applicable divisor” for that age from the above table. “A” divided by “C” equals the MRD for the Distribution Year. (In the age-71½ Distribution Year, first reduce the “A” number by the amount of any required distribution for the age-70½ year that had not been taken out by the end of that year.) This table does not apply to beneficiaries of a deceased IRA owner; or if the sole beneficiary of the IRA is the participant’s spouse who is more than 10 years younger than the participant. This table and method may NOT be used for: pre-2001 distributions (including year 2000 distributions taken in 2000 or 2001) or post-2002 distributions.

Editor’s note: This table was replaced by the new “Uniform Lifetime Table” in 2002. The “new ULT” must be used to compute required distributions for years after 2002 and may be used for 2002 distributions.