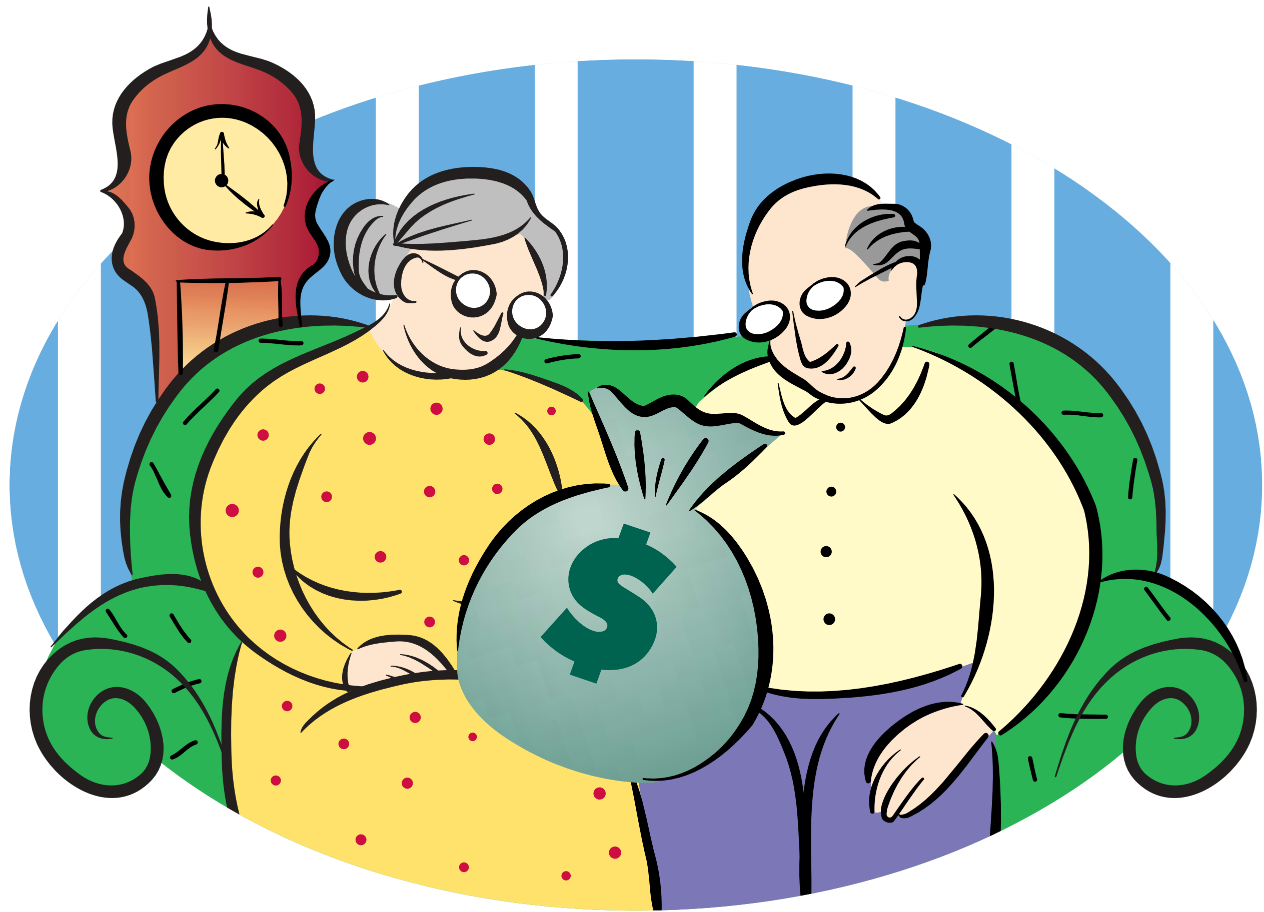

The IRS's New Proposed Rules for Required Minimum Distributions

By Jonathan A. Levy

For this relief much thanks.
—Hamlet, act 1, sc. 1

Shakespeare's line describes the new, proposed regulations for required minimum distributions from qualified plans, IRAs, Code § 403(a) annuities, and Code § 457 plans. 66 Fed. Reg. 3,928 (Jan. 17, 2001) (corrected at Internal Revenue Bulletin No. 2001-1, Mar. 12, 2001). The new rules will simplify compliance for owners, plan participants, and beneficiaries of retirement accounts. They will also permit many taxpayers to reduce the pace of their required withdrawals. For those with sufficient means, stretching out required distributions remains the prize, permitting retirement savings to compound for years or decades without the drag of current taxation.

This article sketches the highlights of the new rules. For convenience, the article uses the term "owner" to mean either an IRA owner or an employee with some other retirement account. "MRD" is shorthand for "minimum required distribution," and "RBD" stands for "required beginning date." "Prop. Reg." refers to the new proposed regulations, rather than to earlier versions.

Background and Effective Date

The new rules replace existing "proposed" regulations that, for fourteen years, have been, in large part, the only regulatory guidance for interpreting Code § 401(a)(9) and the other minimum distribution provisions of the Internal Revenue Code. *See* 52 Fed. Reg. 28,070 (July 27, 1987); 62 Fed. Reg. 67,780 (Dec. 30, 1997). The IRS intends to adopt these new rules in final form for distributions in 2002 and later calendar years. IRA owners need not comply with the new rules for distributions in the 2001 calendar year, but nearly all taxpayers will prefer the new rules. If the IRS adopts final regulations that are more restrictive than the proposed rules, the changes will not be applied retroactively.

Plan sponsors need not conform to the new rules until 2002, but non-IRA sponsors may elect to invoke the new rules in 2001 if they adopt a model amendment contained in the rules. Without this amendment, owners and beneficiaries of non-IRA accounts cannot take advantage of the new rules.

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Distributions During Owner's Lifetime

The heart of the new rules is a new uniform table for calculating required distributions during the lifetime of an account owner. Prop. Reg. § 1.401(a)(9)-5, A-4. As before, distributions must begin by the RBD, normally April 1 of the calendar year after the calendar year in which the owner turns 70½. (But the RBD is delayed until retirement for employees who are neither 5-percent owners nor IRA owners.) In essence, the MRD for each year equals (1) the account balance at the end of the prior year, divided by (2) the "applicable divisor" from the uniform distribution table that corresponds to the owner's age reached during the year of distribution.

For most owners, the amounts of required distributions no longer depend on the age of the owner's designated beneficiary. Also, owners no longer must decide whether to "recalculate" their life expectancies or the life expectancies of their spouses. This decision, required under the former proposed rules, presented owners with a dilemma. Recalculation, as opposed to using fixed-term life expectancies, meant smaller required payments during the lives of the owner and spouse whose lives were being recalculated. But the bill for recalculation came due at the owner's death. The owner's (or spouse's) life expectancy became zero, MRDs accelerated, and in some cases the entire balance had to be withdrawn in the year after death.

The new rules offer the best of both the recalculation and the fixed-term methods. The uniform table assumes recalculation during the owner's lifetime. It also assumes that the owner is married, with a spouse who is ten years younger, and applies their *joint and last survivor life expectancy* on a recalculated basis. (Readers will recognize this as the former Minimum Distribution Incidental Benefit table appearing in Appendix E of Publication 590.) As is explained below, the new rules automatically convert to the fixed-term method at the owner's death, avoiding the brutal acceleration of required withdrawals after death with the recalculation methods.

A simple example in the table below illustrates the benefit of the new uniform table. Consider a married owner, age seventy-three, with a seventy year old spouse as the designated beneficiary. The new uniform table requires the owner to withdraw 4.3 percent of the previous year-end balance. Under the prior rules, the owner would have had to withdraw between 5.1 and 7.2 percent of that balance, depending upon when the spouses' birthdays fell during the calendar year, whether the owner named the spouse as the designated beneficiary by the RBD, and whether the spouses recalculated their life expectancies.

A small minority of owners—namely those with a spouse as sole beneficiary who is more than ten years younger—should not use the uniform table. Instead, they may calculate MRDs using their actual joint and last survivor life expectancies as shown on Table II of IRS Publication 590. This method, like the new uniform table, gives the owner the benefit of the best of both the recalculation and the fixed-term methods.

Distributions After Owner's Death

As with the earlier proposed rules, MRDs after the owner's death depend on whether there is an individual designated beneficiary. But the RBD is no longer a trap for the unwary. Designated beneficiaries are now determined as of the owner's date of death or, in some cases, even as late as the end of the calendar year after the year of death. Thus an owner may now name or change designated beneficiaries after the RBD without ill effect.

Effect of the New Rules

	Distribution period in years	RMD as % of prior year-end account balance (approximate)
New uniform table	23.5	4.3
Publication 590,Table I (single life expectancy for 73 year old)	13.9	7.2
Publication 590, Table II (joint and last survivor expectancy for 73 & 70 year olds, assuming recalculation)	19.4	5.2
Publication 590, Table II (joint and last survivor expectancy for 73 & 70 year olds; assume no recalculation)	18.7 to 19.5 (depending on spouses' birthdays)	5.1 to 5.3 (depending on spouses' birthdays)

If the designated beneficiary is an individual, MRDs for years *after* the owner's death are normally based on the beneficiary's single life expectancy, whether or not the owner died before or after the RBD. The MRD for the year *of* the owner's death uses the owner's life expectancy from the uniform table, based on his or her age attained that year. Prop. Reg. § 1.401(a)(9)-5, A-1(c).

Spouse as Sole Designated Beneficiary

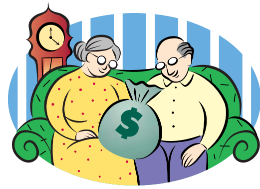
If the owner's spouse is the sole designated beneficiary, the distribution period—that is, the divisor applied to the prior year-end balance to calculate the MRD—is listed in the uniform table corresponding to the spouse's attained age in the distribution year. Prop. Reg. § 1.401(a)(9)-5, A-5(c)(2).

Surviving spouses are favored in three respects. While they are alive, their MRD calculations preserve the benefit of recalculation. If an owner dies before his or her RBD, the spouse need not begin distributions until the year the owner would have become 70½. Prop. Reg. § 1.401(a)(9)-3, A-1(b). Finally, as under the old rules, a surviving spouse may elect to convert or roll over the account to his or her own IRA and to designate new beneficiaries. Prop. Reg. § 1.408-8, A-5 & A-7.

In order to convert an IRA to the surviving spouse's own IRA, the surviving spouse must be the sole beneficiary and must have an unlimited right to withdraw amounts from the IRA. This requirement disqualifies a trust named as IRA beneficiary, even if the spouse is sole beneficiary of the trust. Prop. Reg. § 1.408-8, A-5(a). Also, the spouse cannot make the election until after the RMD is taken for the year of the owner's death. *Id.*

Other Designated Beneficiary

What if the designated beneficiary is not the owner's spouse? The distribution period for the year after the year of the owner's death is the divisor on the uniform table corresponding to the beneficiary's attained age in that year after death. Prop. Reg. § 1.401(a)(9)-5, A-5(c)(1). For each succeeding year,



In order to convert an IRA to the surviving spouse's own IRA, the surviving spouse must be the sole beneficiary and must have an unlimited right to withdraw amounts from the IRA.

the initial divisor is reduced by one. Thus non-spouse beneficiaries cannot recalculate their life expectancies.

If there are multiple non-spouse beneficiaries, the shortest life expectancy controls. Prop. Reg. § 1.401(a)(9)-5, A-7(a)(1). If the spouse and others are designated beneficiaries, the non-spouse rules apply. But, as is explained below, it may be possible to sever the beneficiaries so that better (younger) beneficiaries are not tainted by their less favored (older) beneficiaries.

A plan may permit a designated beneficiary to designate a successor beneficiary for remaining benefits after his or her own death. This does not violate the general prohibition against changing beneficiaries after the owner's death. Prop. Reg. § 1.401(a)(9)-5, A-7(d).

No Individual as Designated Beneficiary

The new rules continue the principle that a non-individual beneficiary does not count as a designated beneficiary. Prop. Reg. § 1.401(a)(9)-4, A-3(a). With a non-individual, the account is treated as having no beneficiary, even if there are also individual beneficiaries. Prop. Reg. § 1.401(a)(9)-5, A-7(d). (Again, it may be possible to sever the beneficiaries to avoid this result.) The actual effect of not having a designated beneficiary depends on whether the account owner survived to his or her RBD.

If the owner survives to the RBD, MRDs for the first year after the year of death are calculated by dividing (1) the account balance, as of the end of the death year, by (2) the owner's remaining life expectancy shown on the uniform table, based on his or her age attained in the year of death. Prop. Reg. § 1.401(a)(9)-5, A-5(c)(3). For each succeeding year, the initial divisor is reduced by one. Again, this reflects the rule that nonspouse beneficiaries cannot recalculate.

The worst outcome occurs if the owner dies without a designated beneficiary before the RBD. The former five-year rule continues to apply. This means that the entire account must be distributed by the end of the fifth year after the year of death. Prop. Reg. § 1.401(a)(9)-3, A-4(a)(3). The silver lining is that no distribution is required until the end of the five years. A beneficiary can wait to withdraw the entire balance at the end of the five years, without incurring the 50 percent penalty under Code § 4974. Prop. Reg. § 54.4974-2, A-8(b).

Estates and Trusts

The IRS has reaffirmed its prior views on the use of estates and trusts as designated beneficiaries. Estates do not qualify. Prop. Reg. § 1.401(a)(9)-4, A-3. Trusts qualify as designated beneficiaries if they meet four requirements: (1) the trust is a valid trust under state law or would be but for the fact that there is no corpus; (2) the trust is irrevocable or will, by its terms, become irrevocable upon the owner's death; (3) the trust beneficiaries are individuals identifiable from the trust instrument; and (4) certain documentation has been provided to the plan administrator. Prop. Reg. § 1.401(a)(9)-4, A-5 & A-6. If a trust has more than one beneficiary, the life expectancy of the oldest controls; if the trust has a non-individual beneficiary, it is treated as not having a designated beneficiary. Prop. Reg. § 1.401(a)(9)-4, A-5(c), § 1.401(a)(9)-5, A-7. It appears that the designated beneficiaries, through a trust, are determined as of the end of the year after the year of death. Prop. Reg. § 1.401(a)(9)-4(c), A-5(b).

A caution here is in order: although trusts may qualify as designated beneficiaries, that is not the end of the inquiry. Both deciding whether to name a trust for estate planning purposes and ensuring that all beneficiaries are identifiable can be tricky. *See* Jonathan A. Levy, *An Update on Making Retirement Benefits Payable to Trusts*, 14 Prob. & Prop., Nov./Dec. 2000, at 24.

Remedial Strategies

A key feature of the new rules is that designated beneficiaries are determined as of December 31 of the year after the year of the owner's death. Prop. Reg. § 1.401(a)(9)-4, A-4(a). Any beneficiary that is eliminated between the date of death and the December 31 deadline is disregarded in determining designated beneficiaries. This approach suggests three possible strategies to slow the pace of required withdrawals when there are disfavored beneficiaries—that is, elderly individuals or non-individuals.

First, disfavored beneficiaries may disclaim their interests in an account before the December 31 deadline. Normally, this will appeal only to wealthy older relatives of contingent beneficiaries who will take as a result of the disclaimers. Planners should make sure that the disclaimers qualify under state disclaimer law and Code § 2518 to avoid adverse gift-tax consequences. Also, an estate planner recommending disclaimer should review state property and probate law and the relevant documents to confirm that the disclaimed funds will not end up in unexpected hands.

A second technique is to distribute the shares of disfavored beneficiaries before the December 31 deadline. As with disclaimer, the cashed-out beneficiaries are disregarded in calculating MRDs. This technique will prove useful with charitable beneficiaries, who will not bear income tax on distributions, accelerated or not, and who will be pleased to be paid early.

A third technique is to split the retirement account into separate shares (or separate accounts, for defined-benefit plans) before the December 31 deadline. *See* 2001-11 I.R.B. at 868; Prop. Reg. § 1.401(a)(9)-5, A-7(a)(2); Prop. Reg. § 1.401(a)(9)-8, A-2. A separate account is a portion of the owner's plan benefit determined by acceptable separate accounting, including allocating investment gains and losses, contributions, and forfeitures, on a pro rata basis. Prop. Reg. § 1.401(a)(9)-8, A-3. The RMDs of each share are calculated separately. *Id.* Thus, the shorter (or zero) life expectancies of older beneficiaries or charities will not accelerate distributions for younger beneficiaries. As a practical matter, however, it is better for owners with diverse beneficiaries to transfer retirement benefits to separate IRAs during their lifetimes. Many plan sponsors are not set up to handle separate-share accounting.

New RMD Reporting

The new rules, once they become final, will require IRA sponsors to report annual RMDs to the IRS. The idea is that the simpler RMD calculations should be enforced more vigorously. The IRS is also considering similar reporting for Code § 403(b) contracts.

Conclusion

The new proposed rules remove some pitfalls of minimum required distributions. Many clients will now be able to take withdrawals more slowly. Others now have a second chance to correct unsound existing beneficiary designations. Nonetheless, although the new rules are simpler, they are still not simple. Estate planners should study their actual text and perhaps consult other, more detailed commentary, including Natalie Choate's article at **www.ataxplan.com**, Noel Ice's comments at **www.trustsandestates.net**, and *New IRA Uncertainties—Waiting for IRS to Fill in the Blanks on the New Regs, in* Ed Slott's IRA Advisor, May 2001, at 2. ■