RETIREMENT PLANNING DISTRIBUTION RULES

In January 2001, the IRS issued new rules that make sweeping changes in how "Minimum Required Distributions" are calculated for IRAs and other retirement plans. These changes potentially affect everyone who has an IRA or other retirement plans. Surprisingly, the changes are almost all good: the necessary calculations have become simpler and the new methods produce smaller required distributions for most people.

There are also changes in how beneficiaries who have inherited IRAs and other retirement plans are to calculate their required distributions from those inherited plans. The new rules are optional for the year 2001 and mandatory for the year 2002. The rule changes do not affect Roth IRAs because there are no required distributions during life from a Roth IRA.

A. Requirement to Make Minimum Distributions

What has not changed are the penalties that apply if an account holder fails to make the required minimum distribution from the IRA or qualified retirement plan.

In order to force qualified retirement plan or IRA accounts to be used to provide retirement income, Congress enacted two significant penalties on account beneficiaries for non-retirement uses of these assets. First, there is a 10% penalty tax for most distributions before age 59½. Second, there is a 50% penalty tax imposed on the account owner for not taking out the required minimum distributions after attaining the age of 70½ or retiring, whichever occurs later. The 50% penalty tax also applies after the account owner's death to beneficiaries who fail to receive the post-death minimum amounts.

The usual tax planning strategy that most advisors follow is to structure IRA and qualified retirement plan accounts in such a way that only the smallest amounts will be required to be distributed. Smaller distributions permit greater amounts to remain in the qualified retirement plan or IRA account and thereby produce greater income tax deferral. As a practical matter, most planning focuses on IRAs rather than company retirement plans. Many companies choose to distribute account balances in full upon an employee's retirement or death to eliminate the burden of maintaining the account, even though the tax laws would permit distributions to occur over a much longer time period. By comparison, the banks and mutual funds that administer IRAs are generally very willing to retain the accounts for extended periods of time.

B. Changes Made by the New Distribution Rules

There are four main changes made by the new minimum distribution rules.

1. Required Distributions During Lifetime

For lifetime required distributions, there is now a simplified method for calculating required distributions at and after the required beginning date. From now on, almost all individuals will use one "Uniform Table" for calculating lifetime required distributions, regardless of who is named as beneficiary and eliminating the need to elect a method of determining life expectancy. The Uniform Table appears at the end of this outline.

2. Post-Death Distributions

For post-death required distributions, the required minimum distributions will be based upon 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 of the "required beginning date or date of death, whichever occurred first."

3. Ability to "Cleanup" Beneficiary Designation After Death

The identity of the post-death designated beneficiary is not finalized until the end of the year following the year of the death, allowing some "cleanup" to be done via post-mortem planning (disclaimers, divisions and distributions).

4. "Recalculating" Life Expectancy

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).

5. No "Penalty" for Changing Beneficiary

It is now possible to change the beneficiary of a retirement account at any time. Under the current rules, changing a beneficiary can lead to larger distributions, but never smaller distributions, even if the new beneficiary has a longer life expectancy. The new system will allow complete freedom to select designated beneficiaries with no impact on the minimum distribution requirement.

C. New Required Distribution During Lifetime

1. General Rule

Under the new system, for purposes of calculating lifetime distributions, it no longer matters who is named as the beneficiary of the retirement account (with one exception noted below). Everyone (except for an account holder who is married to a spouse who is more than ten years younger) will use the new "Uniform Table" to calculate his or her required distributions.

a. Calculating the Required Distribution. The first step is to determine the retirement account balance as of the last day of the preceding year. Next, divide the balance of the retirement account by the distribution period shown for the age the account holder will be by the end of the year.

b. How Tables Were Derived. The "distribution periods" in the Uniform Distribution Table are based upon the life expectancy of an account holder and a designated beneficiary who is ten years younger than the account holder. The life expectancies shown in the table reflect the fact that the life expectancies are recalculated as the account holder ages.

c. Example. Jane IRA was born October 15, 1931. She becomes 70½ on April 15, 2002 and her required beginning date is therefore April 1, 2003. If the value of the IRA on December 31, 2001 is $25,300, then based on her age of 71 during calendar year 2002, her minimum distribution is $1,000 ($25,300 divided by 25.3).

d. Retirement Accounts Will Continue to Grow After Age 70½. Since the distributions start at about 4%, most IRA owners will earn 6% to 9% and thus accumulate excess income during their 70's. Only in later years when the pay-outs increase will all income and some of the IRA principal be distributed. For example, an IRA owner earning 7% will not start to invade principal until age 85. A person earning 9% will not start to invade principal until age 89. Thus, the vast majority of individuals will have from 40% to 80% more value in their IRA when they pass away then they do at age 70½.

2. Exception: Spouse Is More Than 10 Years Younger

If the account holder is married and if the sole beneficiary is his or her spouse, and the spouse is more than ten years younger, then required minimum distributions are calculated using the "joint and survivor life expectancy" of the account holder and his or her spouse. This will produce an even smaller required distribution than the Uniform Table.

D. New Required Distributions After Death of Account Holder

After the death of the account holder, the required minimum distributions depend upon who is treated as the beneficiary or the IRA or retirement plan.

1. Spouse of the Beneficiary

a. Account Holder Dies Before Age 70½ The minimum required distributions are based upon the surviving spouse's life expectancy redetermined each year beginning no later than (i) the year of the account holder's death, or (ii) the year the deceased account holder would have been age 70½.

b. Account Holder Dies After Age 70 ½. The minimum required distributions are based upon the life expectancy of the surviving spouse and recalculated each year.

c. Option: Spousal Rollover. The surviving spouse may elect to "roll over" the IRA account into her own IRA (commonly known as a "spousal rollover").

2. Child Named as Beneficiary

If a child is the beneficiary, the minimum required distributions will be based upon the life expectancy of the child. The applicable distribution period will be reduced by one for each year thereafter (i.e. the child's life expectancy is not recalculated each year).

Example. A child who is age 50 the year after the death of the IRA owner has an applicable distribution period of 33.1. The distribution at age 50 would be the end of year IRA value for the prior year times 1/33.1. The next year, the fraction will be 1/32.1. Each following year, the denominator will be reduced by one until the fraction eventually becomes 1/1 and the entire balance is distributed to the beneficiary.

3. Multiple Children Named As Beneficiaries

If multiple children are named as beneficiaries, then the child with the shortest life expectancy will be used for the calculation. All of the children will receive the same distribution, based upon the age of the oldest child the year after the death of the account holder. However, if a basis for separate shares can be established, then each child will be able to use his or her own life expectancy.

4. Trust Named As Beneficiary

If certain requirements are met, the minimum distributions required to be made to a trust will be based upon the life expectancy of the trust's beneficiary (or the life expectancy of the oldest beneficiary if there are multiple beneficiaries).

5. Charity Is Named As A Beneficiary

If a charity is named as a beneficiary, and the account holder dies before age 70½, then the entire account must be paid out within five years of the account holder's death. If the account holder dies after age 70½, the minimum distributions are based upon the life expectancy of the account holder as of the year of his or her death. A charity will always choose to withdraw the entire amount from the retirement account immediately since the charity is exempt from income tax. However, the minimum distribution requirements applicable to charities are important because the rules apply to all beneficiaries of a retirement account that has a charity as one of the beneficiaries. Fortunately, the new minimum distribution rules provide methods to alleviate the problems associated with naming a charity and individuals as beneficiaries of the same retirement account.

6. Estates Named As Beneficiaries

If an estate is named as a beneficiary or if the account holder did not name a beneficiary, then the required distribution depends upon whether or not the account holder died before or after age 70½. If the account holder died before age 70½, then the entire retirement account must be distributed within

five years of the account holder's death. If the account holder died after age 70½, the minimum distributions are based upon the life expectancy of the account holder as of the year of his or her death.

E. Required Distributions After Death of Beneficiary

Upon the death of a beneficiary of a retirement account (presuming the beneficiary survived the account holder) the minimum distribution requirements continue under the same method as was used after the death of the account holder, with one exception. If the primary beneficiary is a surviving spouse, then the minimum distributions continue over the spouse's life expectancy, but such life expectancy is not recalculated each year.

F. Planning Under The New Minimum Distribution Rules

The new minimum distribution rules make planning for retirement benefits easier than it was under the prior rules.

1. Year 2001 Distribution

The new minimum distribution rules are optional for the year 2001 and mandatory for the year 2002 and thereafter. Anyone who is currently taking out required distributions but has not yet taken out the required distribution for the year 2001, should not take the required distribution for 2001 until they have determined whether the new rules provide a more favorable result.

2. Taking Advantage Of The "Stretch IRA" Concept

The new rules also make it easier for older clients to take advantage of the "stretch IRA" concept. The tax rules for many years have permitted the long-term tax-deferred pay-out of retirement benefits (i.e. the "stretch IRA" concept) to younger generation beneficiaries (such as grandchildren) after the death of the original IRA owner. However, the old rules made it difficult for individuals over age 70½ to achieve that result. Under the old rules, unless you named a younger generation individual as your beneficiary when you turned age 70½ (and at all time thereafter), your heirs could never take advantage of the "stretch" IRA. The new rules remove this obstacle. Under the new rules, whoever you designate as your beneficiary can enjoy a deferred pay-out of the IRA over his or her life expectancy, regardless of when you named him or her as your beneficiary. It no longer matters whether you named some other beneficiary back when you turned age 70½. If you have considered changing the beneficiary on your retirement plan, but were discouraged from doing so because you were past 70½ so it was "too late" to implement changes, you may want to review the situation again now.

3. Charitable Planning

The old rules made it difficult for a person age 70½ or older to leave retirement benefits to charity. Basically, the old rules penalized individuals who chose to leave benefits to charity after age 70½, by forcing them to take larger distributions from the plan than would have been required if an individual had been named as beneficiary instead of a charity. The new rules remove this disincentive to leave retirement benefits to charity. Under the new rules, leaving retirement benefits to charity does not cause accelerated distributions during life. Therefore, if you have considered leaving all or part of your

retirement plan to charity, but chose not to do so because of the increased income taxes that would have resulted under the old rules, you may want to review the situation again now.

4. Increased Significance of Post-Mortem Planning

Post-mortem planning now becomes more significant than it was before. As before, the most favorable payout of benefits after the participant's death will normally be the life expectancy of a young designated beneficiary (unless the benefits are going entirely to charity). Now, however, the date for determining who is the designated beneficiary is the end of the year after the participant's death. This means that (at least) three types of post-death actions can ameliorate the choice of designated beneficiary to something more favorable:

a. Disclaimer. A result that was in doubt under the old proposed regulations, the IRS now specifies that qualified disclaimers are given effect in determining who is the designated beneficiary. Thus, an older beneficiary (such as a surviving spouse or child) could disclaim the benefits and allow them to pass to a younger contingent beneficiary (such as a child or grandchild) and the younger beneficiary will be the designated beneficiary for purposes of determining the life expectancy period.

b. Establishment of separate accounts. The IRS's multiple beneficiary rule specifies that, where there is more than one beneficiary, all beneficiaries must be individuals or no beneficiary can use the life expectancy payout method, or, if all beneficiaries are individuals, the life expectancy of the oldest beneficiary controls, unless the various beneficiaries' shares constitute "separate accounts." Under the old rules, the "applicable date" was age 70½ or the date of death, if earlier. Under the new rule, the applicable date is the end of the year after the date of death, meaning that a plan left to charitable and non-charitable beneficiaries can be split up into separate accounts after death and then each separate account stands on its own for purposes of determining required distributions to the beneficiary of that account.

c. Eliminating beneficiaries by distribution. Under the new rules, a plan left to charitable and non-charitable beneficiaries (or to both older and younger individual beneficiaries) can be "cured" after death by distributing the shares payable to non-individual (or older) beneficiaries. If the amounts payable to the non-individual (or older) beneficiaries are entirely distributed by the end of the year after the date of death, 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, which would probably be the case if the amounts payable to the charity (or older beneficiary) were expressed as fixed-dollar (pecuniary) amounts, rather than as fractional or percentage shares.