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New Regulations Simplify Required Distributions from IRAs and Certain Qualified Deferred Compensation Plans

By Richard P. Mandel

In April 2002, the IRS released new regulations that greatly simplify the rules regarding required distributions from IRAs and certain qualified retirement plans. This article summarizes these new rules by applying them to the two categories into which each retiree must fall and analyzing the effect of the four possible beneficiary designations available to retirees.

By participating in IRAs or qualified deferred compensation plans, taxpayers normally enjoy some of the most significant tax benefits available under the Internal Revenue Code (I.R.C.). Specifically, they are allowed to fund a retirement account with money usually received on a tax-free basis\(^1\) and have that money grow over their working lifetimes without incurring tax on that growth until the money is withdrawn by the taxpayer or his/her beneficiary. The compounding effect of avoiding income tax for all those years should be obvious, and often results in significant wealth available to individuals approaching their retirement years.

However, in creating these opportunities, Congress was interested in funding retirements; it was not interested in creating opportunities to indefinitely postpone income tax on investments.

Thus, these amounts must eventually be withdrawn and the income tax paid. Failure to withdraw the amounts mandated by Congress and the Internal Revenue Service (IRS) results in a penalty of 50% of whatever portion of the required minimum distribution was not taken by the taxpayer.\(^2\) Thus, the challenge to the individual with significant qualified retirement savings is to continue to defer the withdrawal of funds (thus, continuing the compounding effect of tax savings) for as long as possible—both for him- or herself and for his or her beneficiaries after the participant's death—without incurring the 50% penalty.

The requirement for timely withdrawal of funds from qualified retirement accounts applies to stock bonus plans, pension plans, profit-sharing plans, 401(k) plans, 403(a) plans (which are plans maintained by governments and not-for-profit entities) and qualified annuity contracts.\(^3\) It also applies to Individual Retirement Accounts (IRAs),\(^4\) although not to so-called Roth IRAs (since monies may be withdrawn from Roth IRAs income tax free).\(^5\) This article will discuss the effect of these rules on plans in which each individual maintains a separate account. It will not discuss these rules with respect to annuity contracts and traditional pension plans in which the participant does not have a separate account.

Up until 2001, the rules governing required distributions from individual account qualified retirement plans were some of the most complex applicable to the average taxpayer. The amount required to be distributed annually (and thus, the amount of time available to continue deferral of income tax) depended upon whether the plan participant had named a beneficiary prior to beginning required withdrawals and upon the age and relationship of that beneficiary to the participant.
It further depended upon whether the participant had elected to annually recalculate the life expectancy of both parties, an election that also had to be made prior to the beginning of required withdrawals and which, once made, was irrevocable. Needless to say, in the absence of expensive professional advice, few participants were aware that these decisions were significant and irrevocable; nor were they aware that they were required to be made when they were. Thus, many, if not most, participants were denied the opportunity to attain the maximum time for income tax deferral available to themselves and their beneficiaries. These regulations were little more than traps for the unwary retiree.

On January 17, 2001, the IRS released Proposed Regulations that significantly simplified the rules regarding required distributions from qualified retirement plans. After the required comment period, during which these Proposed Regulations were almost universally praised by practitioners, Final Regulations in virtually identical form were released on April 17, 2002. This article will summarize these new rules by applying them to the two categories into which each retiree must fall:

- The retiree dies prior to the required beginning date of distributions; or
- The retiree dies after such date.

Then for both of these categories, the article analyzes the effect of the four possible beneficiary designations available to retirees:

1. Failing to designate a beneficiary;
2. Designating an individual or individuals other than his/her spouse as beneficiary;
3. Designating his/her spouse as beneficiary; and
4. Designating a trust as his/her beneficiary.

Of course, in order to summarize the regulations pertaining to death before and after the required beginning date of distributions, it is necessary to determine when that date occurs. Simply stated, for all the qualified retirement plans discussed in this article, with two major exceptions, the required beginning date is April 1 of the calendar year following the later of: a) the calendar year in which the participant attains age 70.5 or b) the calendar year in which the participant retires. The two major exceptions apply to participants who are more than 5% owners of the plan sponsor (the employer) and to non-Roth Individual Retirement Plans. In both those cases, the required beginning date is April 1 of the calendar year following the calendar year in which the participant attains age 70.5. By the required beginning date, the participant must have either withdrawn all of his/her account or (if allowed by the terms of the plan) begun a series of annual distributions equal to or greater than the required minimum distribution amount.

Under the old rules, the required minimum distribution for each participant depended upon the joint life expectancy of the participant and the beneficiary designated by the participant. Thus, the goal of extended postponement of distributions could easily conflict with the participant’s choice of beneficiary, putting the participant in a difficult spot. Furthermore, the choice of beneficiary (and the election whether to annually recalculate their joint life expectancies) was required to have been made prior to the required beginning date, a fact often unknown to the participant. All of that has changed under the new regulations.

Under the new regulations, the required minimum distribution for the participant who reaches the required beginning date is derived (with only one exception) from a Uniform Table that assumes that the participant’s beneficiary is ten years younger than the participant. Each year, the participant divides his/her account balance at the end of the previous year by the joint life expectancy set forth on the Uniform Table, and the resulting amount is the required minimum distribution. Thus, the participant is free to designate the beneficiary of his or her choice, even a beneficiary older than the participant, without any adverse tax consequence. In fact, since the choice of beneficiary is irrelevant to the required minimum distribution, the participant need not designate any beneficiary at all at the required beginning date. Furthermore, no election regarding recalculation of joint life expectancy is required, since recalculation of the joint life expectancy is done automatically by the Uniform Table.

The only exception to the use of the Uniform Table occurs in any year during which the partici-
pant designates his/her spouse as the sole beneficiary of his/her account and the spouse is more than ten years younger than the participant. In that case, the participant is directed to a different table that requires his/her account balance to be divided by the joint life expectancy of him- or herself and his/her young spouse. This obviously results in a smaller required minimum distribution and a longer postponement of income taxation—thus, a favorable result for the taxpayer. And since the participant consults this alternate table in each year in which his/her young spouse is designated as beneficiary, annual recalculation of joint life expectancy is again automatic.

Death Prior to the Required Beginning Date
Having established when the required beginning date occurs, it is now possible, as promised earlier in this article, to distinguish between the consequences of the participant's death before and after that date. These consequences, in turn, depend upon whether the participant has designated a beneficiary or beneficiaries of his/her account, and, if so, who the participant has designated. Under the old rules, the existence and identity of these beneficiaries was fixed upon the date of the participant's death. The new rules, however, are more forgiving.

Although the beneficiary or beneficiaries must have been designated before the participant's death, if the existence of any such beneficiary would lead to an undesirable result under the rules explained in the next few paragraphs, such beneficiary may be removed from consideration for tax purposes as long as such removal is accomplished before September 30 of the calendar year following the calendar year of the participant's death. Such removal would normally be accomplished either by a disclaimer by the beneficiary or by cashing out the portion of the account committed to such beneficiary. Thus, it is commonly, but incompletely, stated that failure to designate a beneficiary is a term of art under the Regulations. Contrary to the plain English meaning, a participant is deemed to have failed to designate a beneficiary unless all his/her chosen beneficiaries are natural persons. Corporations, estates, charities, and the like, along with many trusts (see exception below) will not qualify; the existence of any such beneficiary among the list of designations will result in the available payment options to be the same as if the participant had designated no one. Herein lies the significance of the ability to winnow out undesirable beneficiaries through disclaimer or cash-out between the date of death and September of the following year.

Simply stated, the consequence of failure to designate a beneficiary (as such term is defined in the Regulations) in the case of death before the required beginning date is that all funds in the participant's account must be distributed before the end of the calendar year containing the fifth anniversary of the participant's death. This, of course, sharply limits the ability of the account's beneficiaries to continue the compounding of deferred taxation. The only partial bright spot in this is the fact that no distributions need be made until the very last minute; the entire account may be paid out in a lump sum at the end of said fifth year.

Designated Beneficiary Other Than the Participant's Spouse
If, however, the participant has a designated beneficiary or beneficiaries (as defined by the Regulations), the tax consequences of death before the required beginning date are much more beneficial. Although the five-year rule is still available if the beneficiaries desire to postpone any distributions until the fifth year, a designated beneficiary will usually achieve maximum compounded tax deferral (if his/her plan permits) by making annual distributions over the life expectancy of the beneficiary, beginning in the year following the participant's death. In the case of multiple beneficiaries (all of whom qualify as designated beneficiaries), the measuring life will normally be the life of the eldest beneficiary, thus somewhat reducing the benefits of this rule. However, if provided for under the plan, the
new regulations allow the designated beneficiaries to divide the participant’s account into separate accounts for each beneficiary, in which case each new account can be distributed over the life expectancy of the account’s individual beneficiary. The new rules also reverse the position of the old regulations that applied the five-year rule unless the beneficiaries affirmatively elected otherwise. Under the new rules, the life expectancy option is now the default.

**Designated Beneficiary Is Participant’s Spouse**

Special rules apply if the participant dies prior to his/her required beginning date and names his/her spouse as a beneficiary. Of course, a spouse, just like any other designated beneficiary, may choose the normally disadvantageous five-year rule. However, if the spouse is the sole designated beneficiary and the spouse wishes to adopt the beneficiary’s life expectancy option, the spouse may postpone the beginning date of those distributions until the year in which the participant would have reached his/her required beginning date.

This is an especially desirable option should the participant have died at an untimely young age or if the spouse was considerably older than the deceased. In effect, the spouse steps into the shoes of the participant, except that the spouse can use his/her own life expectancy once the distributions get started. Since this option is only available to spouses named as the sole designated beneficiary, the usefulness of the rule allowing cash-out or disclaimer of other claimants is again illustrated.

Perhaps even more valuable to a surviving spouse is the right to roll over the participant’s account into an IRA created by the spouse (or in the case of a deceased’s IRA, simply treat it as his/her own). After the rollover, the IRA is treated as the spouse’s plan for all purposes, including the right to name the spouse’s own beneficiary at his/her death. There would be no required distributions until the spouse reached the spouse’s required beginning date. At that time, required minimum distributions would be calculated in accordance with the Uniform Table, unless the spouse had remarried a much younger second wife or husband. This is often the most desirable option for a spouse who is considerably younger than the participant. It also has the advantage of being available for that portion of the participant’s account allocated to the spouse, even if the spouse is not the sole designated beneficiary.

**A Trust as the Designated Beneficiary**

Under the general rules described above, a trust cannot be a designated beneficiary since it is clearly not a natural person. Thus, in such cases, only the disadvantageous five-year rule would be available. However, under certain prescribed circumstances, if a participant names a trust as the account beneficiary, the beneficiaries of the trust may be treated as the designated beneficiaries, allowing the use of either the life expectancy rules and/or the options available to a spouse.

Under the new regulations, the beneficiaries of a trust may be treated as the designated beneficiaries if the trust meets the following four conditions:

- i) the trust is valid under state law (or would be, if funded);
- ii) the trust is irrevocable, or will be so upon the participant’s death;
- iii) the beneficiaries of the trust and the participant’s account are identifiable from the trust agreement; and
- iv) certain trust documentation has been provided to the plan administrator prior to any distributions having been made from the account to the trust beneficiaries.

**Death On or After the Required Beginning Date**

The old regulations often put a premium on designations and elections made on or prior to the required beginning date. Many participants who lived beyond that date later discovered that they had missed that deadline and were saddled with default choices that greatly compromised their estate plans upon their later deaths.

In addition, under certain circumstances, the old regulations required distribution of the participant’s account before the end of the calendar year following the year of the participant’s death. This one-year rule, when applicable, essentially eliminated any further compounded tax deferral for the participant’s beneficiaries. The new regulations
largely solve both these problems.

**Failure to Designate a Beneficiary**

Under the old rules, if the procedures and definitions resulting in a designated beneficiary had not been complied with by the required beginning date, the participant would be treated as having failed to designate such a beneficiary, regardless of what curative measures she/he may have attempted afterward. As described above, the new regulations do not fix the designated beneficiaries until September 30 of the calendar year following the year of the participant's death. This opens up the possibility of adjusting the result by having beneficiaries disclaim rights or by cashing them out, as described earlier.

However, if the participant had failed to name any qualifying beneficiary before his/her death, or if non-natural persons were still named as beneficiaries on the September 30 date, the participant will be treated as having failed to designate a beneficiary. If such a participant's death occurs on or after the required beginning date, the new rules abandon the one-year rule sometimes applicable under the old regulations and even avoid application of the five-year rule applicable under the new rules applicable to death preceding the required beginning date. Instead, the new regulations allow the account to continue to be distributed over the remaining life expectancy of the participant.

**Designated Beneficiary Other Than The Participant's Spouse**

If there are one or more designated beneficiaries for the account of a participant who dies after the required beginning date, the rules governing this situation are very similar to the rules governing death before such date, as described above. If the plan permits, the new rules allow the designated beneficiaries to choose between distributions over the remaining life expectancy of the deceased participant or distributions over the life expectancy of the designated beneficiaries.

The latter, of course, is usually the preferred option unless the beneficiaries are older than the participant. If this latter option is chosen, and there is more than one designated beneficiary, the beneficiaries must use the life expectancy of the oldest designated beneficiary, as described above.

However, as also described earlier, the beneficiaries may be able to avoid this result by taking advantage of a right to establish separate accounts.

**Designated Beneficiary Is Participant's Spouse**

If permitted by the plan, the options available to a spouse who is a designated beneficiary of a participant dying on or after the required beginning date are essentially the same as for other designated beneficiaries. The spouse may, of course, continue to receive distributions based upon the remaining life expectancy of the deceased participant.

Otherwise, the spouse may elect to receive distributions over his/her own remaining life expectancy if he/she is the sole designated beneficiary, or, in the case of multiple designated beneficiaries, if he/she is the eldest such beneficiary or the beneficiaries have taken advantage of the right to divide the participant's account into separate accounts. Furthermore, unlike other designated beneficiaries, a spouse may take the portion of the account allocated to him or her and roll it over into his/her own IRA, with all the attendant benefits outlined earlier.

**A Trust as the Designated Beneficiary**

As stated earlier, a trust would not normally be treated as a designated beneficiary, since it is not a natural person. Thus, under the new rules, choosing a trust as beneficiary would limit tax deferral options. In the case of a participant dying on or after the required beginning date, the only available option for the trust would be to receive the benefits over the remaining life expectancy of the deceased participant. However, under the correct circumstances, it is possible for the beneficiaries of a trust to be treated as the designated beneficiaries of the plan.

Unfortunately, the old regulations made this very difficult in the case of a participant dying on or after the required beginning date because to qualify, certain documentation had to be presented to the plan administrator and the trust had to become irrevocable no later than the required beginning date (or, if later, the date of the designation of the trust as the account beneficiary). Since most estate plans consist of trusts which do not become irrevocable until the grantor's death, desig-
nating such a trust as beneficiary in one’s estate plan failed to conform to the rules.

Fortunately, the new regulations postpone the date of trust irrevocability and document delivery to September 30 of the calendar year following the calendar year of the participant’s death.27 This makes many of the trusts commonly used in estate planning eligible to serve as beneficiaries of qualified plan accounts and their beneficiaries eligible for treatment as designated beneficiaries, thus allowing them the use of either the life expectancy rules and/or the options available to a spouse.

Conclusion

In summary, the new regulations regarding minimum distribution requirements from qualified retirement plans and IRAs are surely still far from simple. Participants and beneficiaries would still be well advised to seek professional advice in navigating through these waters.

However, the 2002 Final Regulations are certainly a step in the direction of rational simplicity. By eliminating much of the significance of the required beginning date in the choice of beneficiaries and distribution methods, by postponing the finality of the choice of designated beneficiaries until the year following the participant’s death, by eliminating the one-year distribution rule, and by making the use of trusts as beneficiaries more available, the new regulations eliminate many of the traps for unwary taxpayers and practitioners and significantly increase the ability of beneficiaries to postpone income tax on plan assets and achieve the goal of continued compounded pre-tax earnings.

Endnotes

1. Individual employees who are active participants in a qualified deferred compensation plan and whose income exceed a specified amount (adjusted annually) may not deduct their IRA contributions. In 2002, the phase-out of this deduction begins at $34,000 of adjusted gross income for single taxpayers and at $54,000 of adjusted gross income for married taxpayers, filing jointly. The phase-out begins at $150,000 of joint adjusted gross income for an employee who is not an active participant in a qualified plan, but whose spouse is. I.R.C. § 219(g).
2. I.R.C. § 4974.
5. I.R.C. § 408A(c)(5).
10. Treas. Reg. § 1.401(a)(9)-(4) A-4. The 2001 Proposed Regulations set the deadline as the end of the calendar year following the calendar year of the participant’s death, but the deadline was advanced in the Final Regulations for administrative convenience.
11. Id.