THE Pension Digest

Published Since 1984 Collin W. Fritz and Associates, Inc., "The Pension Specialists" November, 1995

IRAs — Required Minimum Distributions

The IRA market is maturing. More IRA owners are age 70 1/2 or older. More IRA owners are dying and their beneficiaries are inheriting their IRAs. Special income tax rules mandate that distributions of a certain amount, and within certain time deadlines be made from IRAs. There are two types of distributions which are mandated — those to be made to the IRA owner before he or she dies and those to be made to the beneficiary after the IRA owner's death. The term used for these distributions is "required minimum distributions." If an IRA owner or an IRA beneficiary fails to take a required minimum distribution by a prescribed deadline, he or she will be assessed a special excise tax equal to 50% of the excess accumulation. If reasonable cause is shown, the IRS may waive the assessment of this excise tax. An excess accumulation is defined to be the difference between the amount which was required to be distributed and the amount which actually was distributed. For example, if the required minimum distribution for David Belle, age 74, for 1995, is $1,200 and he fails to have this amount paid to him by December 31, 1995, then he owes the IRS $600.

This is the time of year when most financial institutions are dealing with required minimum distributions because the majority of IRA owners wait until the end of the year to take their required minimum distributions.

The purpose of this article is to explain the required minimum distribution rules with which an IRA owner, an IRA beneficiary with an inherited IRA, and the IRA custodian/trustee must comply. This article does not address the rules which require minimum distributions from qualified plans and section 403(b) arrangements. With only a few exceptions, the rules which apply to IRAs also apply to qualified plans. An IRA custodian will benefit by being well prepared to perform the tasks which are associated with required minimum distributions. Most IRA owners will look, at least initially, to the IRA custodian or trustee to insure their required minimum distributions are made on time, and to calculate the required amount.

Because the IRA custodian/trustee is a fiduciary with respect to the IRA, most advisors do not feel a financial institution would have a defensible position to simply impose all responsibility on complying with the required minimum distribution rules upon the IRA owner or the IRA beneficiary. Yet, there are limits as to what the IRA custodian needs to do. It is the IRA owner or beneficiary who will be liable to pay the IRS the 50% excise tax if the required minimum distribution is not timely taken. The IRA custodian wants to adopt various procedures to render excellent service, but it also wants to limit an IRA owner's claim that the IRA custodian should assist with paying the 50% excise tax for failing to assist with complying with the required minimum distribution rules.

The tasks which an IRA custodian should perform are the following. First, the IRA custodian must identify those IRA owners and IRA beneficiaries with inherited IRAs who are required to be paid required minimum distributions for a given year. Second, the IRA custodian must furnish these people with an explanation of what their options are for complying with the minimum distribution rules. The furnishing of this information will be valued by an IRA owner or an IRA beneficiary because many IRA owners or beneficiaries will want to understand how their current election will determine or influence future distributions. Most people wish to plan their distributions as best they can with the hope of minimizing the taxes to be paid. Third, the IRA custodian must receive the IRA owner's and the IRA beneficiary's elections. Fourth, the distribution amount for each such person for each year must be calculated and communicated to the person. Fifth, the IRA custodian should try to ensure that the required amount is distributed by the appropriate deadline. This can be accomplished by sending out timely notices. This is a substantial number of tasks, and as this article will demonstrate, the rules are complex because of the numerous factors used to calculate the required amount. There are software products available to make the administration of required minimum distributions easier.

IRAs and employer-sponsored pension plans receive very favorable tax treatment under the Internal Revenue Code. The favorable tax treatment bestowed is that taxation of the amount contributed, plus earnings which derive from such contributions, is deferred until a distribution is paid to the IRA owner. The most often-stated reason for this preferential treatment is that an important societal goal is met when individuals have saved for retirement.

Although having income for retirement is an important social goal, Congress saw a need to not allow a person to avoid forever the paying of income tax on his or her IRA contributions and the related earnings. Thus, the Internal Revenue Code, as written, requires that distributions be made when a person reaches "retirement age" or after he or she dies. Again, the policy goal is to provide for a person's retirement. This policy goal no longer applies once the person dies. The primary purpose behind requiring a distribution is — when a distribution takes place, the recipient will normally include the amount distributed in his/her income.

REQUIRED MINIMUM DISTRIBUTIONS TO IRA OWNERS

Congress concluded that an IRA owner who attains age 70 1/2 during any year has reached the magical "retirement age" so distribution of the accumulated IRA balance must be made in one of the following two ways: (1) the payment of the entire account balance or (2) the payment of certain periodic distributions.

If a person was paid his or her entire account balance, the amount of taxes owing for the year of distribution most likely would be significant. Normally, a person will pay less tax if he or she takes distributions over a number of tax years. Therefore, almost no IRA owner wishes to be paid his or her entire account balance. Rather, most IRA owners prefer to establish a schedule of periodic distributions. Many IRA owners also do not wish to be paid a penny more than the amount they are required. These periodic distributions must equal or exceed a required minimum distribution amount and must be established using one of the following periods:

1. A period that does not extend beyond the IRA owner's life expectancy or

2. A period that does not extend beyond the joint life expectancy of the IRA owner and his or her designated beneficiary.

Be aware that special rules apply if the IRA is an IRA annuity, and these rules are beyond the scope of this article.

The IRA owner must begin to take required minimum distributions for the year in which they turn 70 1/2. The "required beginning date" is the date when these minimum distributions must begin. April 1 of the calendar year following the calendar year in which the accountholder attains age 70 1/2 is the required beginning date. An individual reaches age 70 1/2 six months after the individual's 70th birthday.

Example: David Waller has his 70th birthday on January 23, 1995. Six months after his birthday is July 23, 1995. Therefore, he is 70 1/2 in 1995 and must begin taking distributions no later than 4-1-96. The deadline for taking all subsequent distributions is December 31 of each year. Therefore, his second distribution must be taken by 12-31-96, his third by 12-31-97, etc. As you can see in this example, his first two required distributions will fall in the same calendar year if he waits until 1996 to take his first RMD. Most individuals who attain age 70 1/2 in 1995 will not delay their first distribution into 1996, because if they do, they will need to include both amounts in their 1996 taxable income.

Each year the required minimum distribution amount must be calculated. The following "regular" formula is used to calculate the required minimum unless the MDIB calculation applies and results in a larger required minimum distribution. The MDIB rules are discussed later in this article. The formula — **Account Balance ÷ Life Expectancy Factor = Required Minimum Distribution**

The account balance to be used is the account balance as of December 31 of the immediately preceding year. For example, Joe Participant attains age 70 1/2 on 8-1-95. To determine his 1995 distribution amount, his account balance as of 12-31-94 would be used. His 1996 distribution would be based on the account balance as of 12-31-95; 1997's RMD would be used on the 12-31-96 balance, etc.

There is a special exception which applies if the IRA owner waits to take the first year's distribution until the second year. Example: Joe, born February 1, 1925, reached at 70 1/2 in 1995. His required beginning date is April 1, 1996. Joe's account balance as of December 31, 1994, is $24,000. The joint-life and last-survivor life expectancy for Joe's first distribution year (his 70 1/2 year), is $1,000 ($24,000 divided by 24). This amount is distributed to Joe on April 1, 1996. Joe's account balance as of December 31, 1995 is $26,400. To figure the minimum amount required to be distributed for 1996, the account balance (as of December 31, 1995) of $26,400 is reduced by the $1,000 minimum required distribution for 1995 that was made on April 1, 1996. Thus, the account balance for determining the required distribution for 1996 is $25,400. If this adjustment was not made, those people who use the "grace period" would be penalized.

There is a second exception for outstanding rollovers — funds distributed from an IRA that may be returned to an IRA within 60 days. Any outstanding rollover amount must be added to the December 31 balance of the receiving IRA if it was distributed from another IRA on or after November 2. This would also apply to any outstanding transfers which were not included in any December 31 balance.

The determination of the life-expectancy factor is quite complicated because this factor must be calculated each year. The factor is based upon the age of the IRA owner and the age of the beneficiary, if any, and is also based upon which method the IRA owner has elected to use to determine the factor for years after the year he or she attained age 70 1/2.

To determine the factor for the first year, the first step is to determine whether or not the IRA owner is eligible to use a joint factor or whether the person would be required to use a single factor. Since a joint factor will be greater than the single factor, this means the required minimum distribution amount will be less if a joint factor can be used. Eligibility to use the joint factor depends upon the individual(s) and/or other entities which the IRA owner had designated as his or her beneficiary as of the required beginning date.

If the IRA owner designates only an individual or individuals, then a joint life-expectancy factor will be used. If the IRA owner has designated more than one individual as a primary beneficiary, the oldest primary beneficiary will be the one used to determine the joint factor. The life expectancy of a contingent beneficiary need not be considered, unless a contingent beneficiary becomes a primary beneficiary.

If the IRA owner designates an entity who is not an individual (e.g. estate, church, college, revocable trust, etc.) as a beneficiary, then a single life-expectancy factor must be used.

To determine the factor for the first year, the second step is to determine the age of the IRA owner and the age of the oldest beneficiary. The IRS has published unisex Life-Expectancy Tables which states a factor for a given age or a combination of ages.

To determine the factor for the second year and all subsequent years, the rules require that the IRA owner make an irrevocable election on or before the required beginning date whether or not the recalculation method, the nonrecalculation (one-year reduction), or a special combination method will be used. Most IRA plan agreements provide that the owner will be deemed to have elected the recalculation method unless he or she expressly adopts the one-year reduction method.

What is meant by recalculation and when can it be used? — The term recalculation signifies that the life-expectancy factor is redetermined each year by determining the factor from the life-expectancy charts using the current ages. Only the accountholder and a spouse beneficiary are eligible for recalculation.

What is meant by nonrecalculation or the one-year reduction method? — The one-year reduction method uses the table for the first year but then for each subsequent year the initial factor is reduced by one.

Sample Charts

An example of recalculation, and one-year reduction, using a single life expectancy factor is (assume he or she turns 70 1/2 and 71 in 1995):

Year	Age	Life-Expectancy Factor if Method Chosen is Recalculation	Life-Expectancy Factor if One-Year Reduction
1995	71	15.3	15.3
1996	72	14.6	14.3
1997	73	13.9	13.3
1998	74	13.2	12.3
1999etc.	75	12.5	11.3

Note: Since the factor under the recalculation method is larger, its required minimum distribution will be less than if the one-year reduction method is used.

If there is a named spouse beneficiary, an example of recalculation and one-year reduction with a joint life expectancy follows. Assume that in 1995 the IRA owner turns 70 1/2 and 71 and the beneficiary has his 65th birthday in 1995.

Year	Age	Life-Expectancy Factor if Method Chosen is Recalculation	Life-Expectancy Factor if One-Year Reduction
1995	71/65	22.8	22.8
1996	72/66	21.9	21.8
1997	73/67	21.0	20.8
1998	74/68	20.0	19.8
1999etc.	75/69	19.3	18.8

If an accountholder elects recalculation and has named a nonspouse beneficiary, a special formula must be used. This special formula is a combination of recalculating for the IRA owner and one-year reduction for the nonspouse beneficiary.

What happens under the recalculation and nonrecalculation methods if the IRA owner or the designated beneficiary die, or both die? — The rule is that upon the death of the IRA owner (and/or spouse) the recalculated life expectancy of the IRA owner (or spouse) will be reduced to zero in the calendar year following the calendar year of death. If both the IRA owner and the beneficiary have died and the recalculation method is being used, then the current beneficiary will be required to receive the entire remaining balance on or before December 31 of the year after the year of death. If the nonrecalculation method (one-year reduction method) was being used, then the current beneficiary will be able to continue such schedule. Under either schedule, a spouse beneficiary could discontinue distribution by electing to treat the account as his or her own.

Here is an example showing the difference between the recalculation and one-year reduction methods when the primary beneficiary predeceases the IRA owner. What happens if a beneficiary whose life expectancy is being recalculated dies (e.g. the spouse beneficiary in the above example) in 1996? What happens if the accountholder then dies in 1998?

Year	Age	Life-Expectancy Factor if Using Recalculation	Life-Expectancy Factor if Using One-Year Reduction
1995	71/65	22.8	22.8
1996 (death)	72/66	21.9	21.8
1997 (next yr)	73/0	13.9 (single recalc)	20.8
1998 (death)	74/0	13.2	19.8
1999 (next yr)	0/0	0	18.8
etc.			

Note: This example illustrates the risk associated with the recalculation method. The recalculation schedule changes after a death, the one-year reduction method does not.

What Happens for RMD Calculation Purposes if the IRA Owner Changes His or Her Beneficiary? — A change in the beneficiary after the required beginning date will not normally change the calculation of the required minimum distribution. Exception: If the new designated beneficiary has a shorter life expectancy (i.e. the new beneficiary is older than the original beneficiary or is not a living person) then the new beneficiary is treated as if he or she had been the beneficiary as of the required beginning date to determine the distribution schedule. However, the new schedule is not applied retroactively. Rather, it applies only for the calendar years after the calendar year in which the beneficiary was changed.

Example: In 1995 you were age 70 and 70 1/2. On your required beginning date your son (age 45) was your beneficiary. The one-year reduction method was elected, but the MDIB method applies. In 1997 you name as beneficiary your spouse, who is the same age as you.

Year	Age	Son as Beneficiary (MDIB Applies)	Age	Spouse as Beneficiary
1995	70/45	26.2**	70/70	20.6
1996	71/46	25.3**	71/71	19.6
1997 (new benef.)	72/47	24.4**	72/72	18.6
1998	73/48	--	73/73	17.6**
1999 etc.	74/49	--	74/74	16.6**

The distribution schedule would switch to that based on the spouse in 1998 (the year after the year the change was made).

What is the MDIB Rule or Table? — As mentioned previously, Congress intended that IRAs and other pension plans be used for retirement purposes and not as a never-ending tax deferral tool. Therefore, distributions from an IRA must comply with a special Minimum Distribution Incidental Benefit Requirement (MDIB Requirement). The concept is – after the IRA owner dies, there should only be "incidental" benefits remaining for distribution to beneficiaries; therefore, distributions of a certain size will be mandated while the IRA owner is living.

In general, the MDIB requirement is that a special factor or divisor will need to be used rather than the joint life-expectancy factor as taken from Table VI of the Unisex Life-Expectancy Tables if it will require a larger distribution than the regular RMD calculation would require.

The MDIB requirement applies when the IRA owner designates a beneficiary other than his or her spouse and this beneficiary is more than 10 years younger than the IRA owner. For example, an IRA owner, age 70, designates her daughter, Sara, age 40, as her beneficiary. The joint life-expectancy factor from Table VI is 42.9. The divisor from the MDIB Table is 26.2. The number to use would be the smaller of the two, or 26.2.

The MDIB table is set forth below. Note, the term, "divisor" is used rather than "life expectancy factor."

MDIB Life Expectancy Table
For Determining Applicable Divisor

Age of the IRA Participant	Applicable Divisor	Age of the IRA Participant	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 MDIB table is a special life-expectancy chart. The use of the MDIB table is not elected by the IRA owner. The divisor to be used is based solely upon the age of the IRA owner for the current year. Even if the IRA owner has elected to use the one-year reduction with respect to his or her regular election, the original MDIB divisor of 26.2 or 25.3 is NOT reduced by one to determine the divisor for subsequent years. Return to the table with current age and use related divisor.

Example: Marie Dominquez is age 70 and 70 1/2 in 1995. She has designated her daughter, Teresa, age 45 as her beneficiary. She also elects to use the one-year reduction method. Assume that Maria dies in 1997. The following chart shows which factor would be used in various situations:

Year	Event	Factor From Regular Table	Factor From MDIB Table	Factor to be Used
1995	RMD Elections Made	38.3	26.2	26.2
1996		37.3	25.3	25.3
1997	Death of Maria	36.3	24.4	24.4
1998	Use Regular Schedule for All Years After Death	35.3	N/A	35.3
1999 etc.		34.3	N/A	34.3

If the IRA owner has beneficiaries in addition to his or her spouse, then only that portion of the account of which the spouse is the beneficiary will not be subject to the MDIB rule. And, any such portion must be a separate account (Proposed Regulation 1.401(a)(9)-1). A separate account for IRA purposes would be a portion determined by an acceptable method of "separate" accounting, which would include allocating investment gains and losses and contributions on a pro rata basis in a reasonable and consistent manner between such "separate" portions. Clearly, separate time deposits would suffice, although separate IRAs would be easier administratively.

Alternative Certification Method

Although the required minimum distribution amount must be determined for each IRA maintained by an IRA owner, an IRA owner who maintains multiple IRAs is permitted to total the minimum amounts and take the total from any one or more of the IRAs. An IRA custodian or trustee should receive a written instruction from an IRA owner who will forego taking his or her required minimum distribution from your institution because he or she is taking it from another IRA.

REQUIRED MINIMUM DISTRIBUTIONS TO IRA BENEFICIARIES

Once the IRA owner has died, the societal goal of having money for retirement no longer exists. Thus, the law mandates that the remaining IRA funds be paid to the beneficiary within certain time limits. Again, if the required minimum distribution is not paid out by the deadline for a given year, then the 50% excise will be owed.

The method of calculating the required minimum distribution for an IRA beneficiary depends upon whether he or she is the deceased IRA owner's spouse and whether the IRA owner died before or after his or her required beginning date. Thus, there are four possible situations. The rules vary for each situation.

An informed IRA beneficiary will want and need to consider the following factors before making his or her distribution elections:

1. The age of the IRA owner when he or she died;

2. His or her age, and whether or not he or she is a spouse or nonspouse;

3. The IRA account balance at the time of the IRA owner's death;

4. The possibility that he or she may die before the inherited IRA balance has been totally depleted, and what the balance would be at that time;

5. If applicable, the RMD election and periodic payment instruction which the IRA owner had made (if the IRA owner was 70 1/2 or older);

6. His or her need for cash in the short run (one to two years) and in the long run (beyond two years);

7. The tax bracket which will apply to the distributions to be made to him or her, or to his or her estate, or to other ultimate beneficiaries;

8. The institution's policies on continuing to pay the interest rates which applied to the time deposits purchased by the decedent.

The four possible situations are as follows:

Situation #1:

Spouse Beneficiary and IRA Owner Died on or After the IRA Owner's Required Beginning Date

The surviving spouse can treat the decedent's IRA as his or her own, or the spouse must continue the required minimum distribution schedule which the IRA owner had established.

Most surviving spouses will make the election to treat the decedent's IRA as his or her own. If the surviving spouse elects to treat the IRA as his or her own, the required minimum amount for the year of death, if it had not been distributed, is not required to be distributed to the spouse.

If the spouse decides to continue the IRA owner's schedule, then the spouse must be paid the required minimum by December 31 of the year the IRA owner died and each December 31 thereafter. The title on the IRA would become, "John Doe as IRA beneficiary of Jane Doe."

If the spouse decides to continue the IRA owner's distribution schedule, then the spouse must be paid the applicable minimum by December 31 of the year the owner died and each December 31 thereafter. For the following year, the factor to be used with respect to the deceased IRA owner will depend upon whether the IRA owner had chosen to use the recalculation method or the one-year reduction method. If the IRA owner had chosen to recalculate life expectancies, the spouse beneficiary will have to take distributions over his or her single life expectancy. If the IRA owner had chosen to use the one-year reduction method, the schedule will not be changed — the original joint factor will continue to be reduced by one for each year which passes.

Situation #2:

Spouse Beneficiary and IRA Owner Died Before the IRA Owner's Required Beginning Date

The surviving spouse has three options. The spouse may elect to treat the deceased IRA owner's IRA as her or her own. The right of the spouse to treat the IRA as his or her own is apparently unlimited and may be elected even if one of the other options was already chosen. The spouse is most likely to elect to treat the deceased spouse's IRA as his or her own if the spouse is older than 59 1/2 or if he or she has no need for the funds. The second option is to choose the five-year rule which allows the spouse five full calendar years plus the remaining portion of the year of death to withdraw the entire account balance in partial payments or in a lump sum. The third option is for a spouse to choose the life-distribution rule. This rule allows a surviving spouse to establish a periodic payment schedule. The minimum distribution for each year equals the balance as of the preceding year divided by the spouse's single life expectancy. The spouse must commence the distribution schedule no later than December 31 of the year the IRA owner would have attained age 70 1/2. The spouse may choose to use the recalculation method or the one-year reduction method to determine the applicable life-expectancy factor for distribution years after the first year.

Situation #3:

Nonspouse Beneficiary and IRA Owner Died on or After the IRA Owner's Required Beginning Date

A nonspouse beneficiary must continue or accelerate the "regular" distribution schedule which the IRA owner had established. The application of this rule is not as simple as it sounds, however.

Remember that the MDIB schedule overrides the "regular" schedule when the nonspouse beneficiary is more than 10 years younger than the IRA owner, and that the MDIB schedule will no longer apply after the IRA owner dies.

If the beneficiary was not more than 10 years younger, then the "regular" joint life-expectancy schedule will continue as if the one-year reduction method had been elected. If the recalculation method had been elected, then the joint schedule will change to a single life expectancy as follows. The age of the beneficiary is determined as of the year the IRA owner attained age 70 1/2, and the applicable factor is determined. This factor is then reduced by one for each elapsed year until the current year's factor is determined.

If the beneficiary was more than 10 years younger so that the MDIB schedule was applied, there must be a reversion to the "regular" schedule for the year following the year of death. The "regular" joint life-expectancy schedule will continue as if the one-year reduction method had been elected. If the recalculation method had been elected, then the joint schedule will change to a single life expectancy as follows. The age of the beneficiary is determined as of the year the IRA owner attained age 70 1/2, and the applicable factor is determined. This factor is then reduced by one for each elapsed year until the current year's factor is determined.

Situation #4:

Nonspouse Beneficiary and IRA Owner Died Before the IRA Owner's Required Beginning Date

A nonspouse beneficiary has only two options. The options are very similar to those which apply to a spouse beneficiary. However, a nonspouse beneficiary does not have the right to elect to treat the decedent's IRA as his or her own. That is, the IRA will always be an "inherited IRA."

The first option is to choose the five-year rule which allows the nonspouse beneficiary five full calendar years plus the remaining portion of the year of death to withdraw the entire inherited account balance in partial payments or in a lump sum. Many times IRA beneficiaries feel that the five- to six-year period is an adequate period in which to take partial payments to minimize the income tax to be paid. This is especially true if the IRA balance is not significantly large. The second option available to the nonspouse beneficiary is to use the life-distribution rule. As IRA balances grow, and as IRA beneficiaries become more knowledgeable, more beneficiaries are starting to make this election.

This rule allows the establishment of a periodic payment schedule. This schedule must commence no later than December 31 of the year after the IRA owner's death. The minimum distribution amount for each year equals the balance as of the preceding year divided by the nonspouse's life-expectancy factor. The nonspouse beneficiary must use the one-year reduction method to determine the applicable life-expectancy factor for distribution years after the first year.

Summary

IRA owners are becoming older and more IRA owners are dying each year. Annually, every IRA custodian/trustee is having to deal with more required minimum distributions. An IRA custodian with well-established policies, procedures and informed personnel will be able to service these "special" IRAs well. PD