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ALSO IN THIS ISSUE –

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IRS REVISES RULES FOR SUBSTANTIALLY EQUAL PERIODIC PAYMENTS

On October 21, 2002, the IRS issued Rev. Rul. 2002-62. The IRS did so for at least two reasons. First, the IRS decided to give some special relief to certain taxpayers. Second, the IRS used the opportunity to state some new rules which apply to substantially equal periodic payment schedules. Distributions pursuant to such a schedule are not subject to the 10% additional tax. A recapture tax is imposed if the accountholder modifies the schedule prior to when he or she is eligible to do so.

As we all know, the value of many IRAs has decreased substantially because of the tremendous fall-off in the stock market. Some of these IRAs are owned by IRA accountholders who had established a substantially equal periodic payment schedule.

As an example, let's assume an individual, Ms. Denise Roberts, had set up a substantially equal periodic payment schedule in 1996. The initial calculation to set up the schedule was based on the account having a fair market value of $185,000. Denise's date of birth is June 10, 1950, and she chose the amortization method for the schedule. The earnings rate used was 6.0%; this resulted in an annual distribution of $12,577 since 1996. Because of market fluctuations, the current value of the IRA is $65,000 (leaving only slightly more than 5 years of distributions before the account is depleted). Under the newest IRS rules (described below), Ms. Roberts will be allowed to choose the RMD method without incurring any additional tax penalty, because this action will not be deemed a "modification" of her original schedule. Electing the RMD method will also result in a smaller annual RMD amount.

The IRS had been asked, "If a modification of the schedule occurs in certain situations, would the special recapture tax apply?" For example, would the 10% recapture tax apply if the account would become valueless before the person was eligible to change the schedule?

In Notice 89-25 the IRS had created three safe harbor methods for establishing a substantially equal periodic payment schedule. The IRS has now chosen to implement the following new rules (i.e. safe harbors) in Rev. Rul. 2002-62:

1. A schedule modification will occur if there is "any addition" to the account balance other than earnings or losses. No longer is it permissible to contribute to an IRA (be it an annual contribution, rollover or transfer) with respect to which a schedule has been established.

2. A schedule modification will occur if there is any nontaxable transfer of a portion of the account balance to another retirement plan. It appears that the IRS has concluded that they don't want a person to be able to move his or her IRA from one custodian/trustee to another.

3. A schedule modification will occur if the accountholder rolls over a distribution under the schedule. Note that under pre-2003 rules, although such a rollover would have contravened the concept of a series of distributions, the rules did not clearly prevent the rollover. Such rollovers essentially allowed the accountholder to lessen the amount of the distribution. The IRS has made it clear that such rollovers in 2003 will result in a modification of the schedule.

4. The permissible life-expectancy tables are the three tables which the IRS released in conjunction with the final RMD regulation. Once the table is selected, it must be used for subsequent years. The age of the accountholder on the accountholder's birthday in that year is used to determine the factor for that year. If the accountholder wants to use a

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joint schedule, then the RMD beneficiary rules apply to determine which beneficiary will be used in the calculation, with the following changes. If the original "measuring" beneficiary is eliminated, then, for years after the elimination, that individual would not be taken into account. And the single table will again be used for a given year if there is no designated beneficiary in any year. The age of the beneficiary on the beneficiary's birthday in that year is used to determine the factor for that year.

5. An accountholder who had established a qualifying substantially equal periodic payment schedule prior to 2003 by use of either the amortization method or the annuity factor method is authorized to switch to the RMD method at any time, as long as the RMD method is used for all subsequent years. This switch does not result in a schedule modification.

6. An accountholder who initially establishes a qualifying schedule in 2003 or later using either the amortization or the annuity factor method will be able to switch to the RMD method to determine the payment for the year of the switch and for all subsequent years, and the change will not result in an impermissible modification. The annual payment amount is the same amount each year under the fixed amortization and the fixed annuitization method. The annual payment amount may differ each year under the RMD method, as long as such change is not due to a switch to another method of calculating the annual amount.

7. The mortality table to be used in the fixed annuity method is derived by using the mortality table which the IRS issued with the Rev. Rul. The use of a different mortality table will no longer qualify for the safe harbor. Apparently too many people were shopping for the mortality table they would use.

8. The account balance used within any of the three methods must be determined in a reasonable manner based on the facts and circumstances. The IRS does not give as much guidance as is desired. Good guidance is given with respect to the RMD method, but not for the other two methods. An example is provided which indicates that a 6 1/2 month look-back period is reasonable for determining the value of the account to be used in the calculation if the RMD method is being used. If the first distribution is to be made on July 15, 2003, then, in the case of an IRA valued on a daily basis, it will be reasonable to use the value of the IRA from December 31, 2002, to December 15, 2003. For subsequent years, it would be reasonable to use the value either on December 31 of the prior year, or on a date within a reasonable period before that year's distribution.

The IRS does not discuss the topic of when the distributions must take place in subsequent years.

9. The IRS does define how the interest rate to be used in the calculation is to be determined. The interest rate must not be more than 120% of the federal mid-term rate for either of the two months immediately preceding the month in which the distribution begins. Set forth below are such rates for 2002.

10. A schedule modification will not occur if an IRA's assets are exhausted as a result of following a qualifying schedule, and the distributions for the final year will not be subject to the 10% additional tax even though the full distribution for that year is not made as required by the schedule.

11. The new rules apply for any series of payments (substantially equal periodic payments) starting on or after January 1, 2003. The rules in Notice 89-25 are no longer a safe harbor unless the rules in this Rev. Ruling are satisfied. An IRA accountholder is not required by law to use one of the safe harbors. However, if the accountholder wishes to use a method other than one of the safe harbors, he or she should be required to furnish an attorney's or accountant's opinion letter and hold harmless agreement to the IRA custodian/trustee.

The IRS has been quite restrictive in defining the qualifying interest rate as, "any rate which falls within the range created by using the federal midterm rate of 120% for the two months preceding the commencement of the series of distributions." For illustration purposes, we have created a chart to show what the permissible interest rates would have been for 2002. Note that because the rates for the two preceding months are generally known relatively early, a taxpayer already knows what rates may be used for distributions commencing in December 2002 or January 2003.

Interest Rate Schedule for 2002 and Subsequent Years	Permissible Range of Upper Limit	Actual Rate for That Month (Used for Reference Only)
August	5.53 - 5.71%	5.10%
September	5.10 - 5.53%	4.51%
October	4.51 - 5.10%	4.16%
November	4.16 - 4.51%	3.68%
December	3.36 - 4.16%	3.98%
January	3.68 - 3.98%	????%

IRS ISSUES QUESTIONS & ANSWERS—SUBSTANTIALLY EQUAL PERIODIC PAYMENTS

The IRS recently released the following questions and answers. These frequently-asked questions and answers are provided for general information only, and should not be cited as any type of legal authority. They are designed to provide the user with information required to respond to general inquiries. Due to the uniqueness and complexities of Federal tax law, it is imperative to ensure a full understanding of the specific question presented, and to perform the requisite research to ensure a correct response is provided.

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1. What is the additional income tax under section 72(t)(1) of the Internal Revenue Code? Section 72(t)(1) provides that an additional tax of 10 percent will be imposed on the amount includable in income with respect to a distribution from a qualified retirement plan as defined in section 4974(c). Various exceptions to this tax are set forth in section 72(t)(2).

2. What is the exception in section 72(t)(2)(A)(iv)? Section 72(t)(2)(A)(iv) provides, in part, that if distributions are part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancy) of the employee and beneficiary, the tax described in section 72(t)(1) will not be applicable. Pursuant to section 72 (t)(5), in the case of distributions from an IRA, the IRA owner is substituted for the employee for purposes of applying this exception. Section 72(t)(4) provides that if the series of substantially equal periodic payments that is otherwise excepted from the 10% tax is substantially modified (other than by reason of death or disability) within a five-year period beginning on the date of the first payment, or, if later, age 59 1/2, the exception to the 10% tax does not apply, and the taxpayer's tax for the year of modification shall be increased by an amount which, but for the exception, would have been imposed, plus interest for the deferral period.

3. Has the Service issued guidance on this exception? Yes. In Q&A-12 of Notice 89-25, 1989-2 C.B. 662, the Service published guidance with respect to certain types of plans. In particular, Q&A-12 of Notice 89-25 pertains to individual account plans (including tax-sheltered annuities under section 403(b)) and individual retirement arrangements (both individual retirement accounts and individual retirement annuities). Q&A-12 of Notice 89-25 sets forth three methods that may be used in determining what are substantially equal periodic payments for purposes of section 72(t)(2)(A)(iv) of the Code. These are (1) a variable method, which is the required minimum distribution method, (2) a fixed amortization method, and (3) a fixed annuity method.

4. Are there new rules that may be used for calculating substantially equal period payments under section 72(t)(2)(A)(iv)? Yes. These new rules can be found in Rev. Rul. 2002-62, 2002-42 I.R.B. 710,. which was made public on October 3, 2002, before its publication in issue 2002-42 of the Internal Revenue Bulletin on October 21, 2002. Rev. Rul. 2002-62 consolidates the descriptions of the methods in one place and describes the components of the various methods.

5. Generally, when are these rules effective? The rules are effective for all payments commencing on or after January 1, 2003. However, see Q&A-9 for a transitional rule.

6. What are the components of the required minimum distribution method? The required minimum distribution method consists of an account balance and a life expectancy (single life or uniform life or joint life and last survivor each using the age(s) attained in the year for which distributions are calculated). The annual payment is redetermined for each year.

7. What are the components of the fixed amortization method? The fixed amortization method consists of an account balance amortized over a specified number of years equal to life expectancy (single life or uniform life or joint life and last survivor) and a rate of interest that is not more than 120% of the federal mid-term rate published in revenue rulings by the Service. Once an annual distribution amount is calculated under this fixed method, the same dollar amount must be distributed under this method in subsequent years.

8. What are the components of the fixed annuitization method? The fixed annuitization method consists of an account balance, an annuity factor, and an annual payment. The age annuity factor is calculated based on the mortality table in Appendix B of Rev. Rul. 2002-62 and a rate of interest that is not more than 120% of the federal mid-term rate published in revenue rulings by the Service. Once an annual distribution amount is calculated under this fixed method, the same dollar amount must be distributed under this method in subsequent years.

9. If an individual began receiving substantially equal periodic payments before calendar 2003 using one of the three methods in Notice 89-25, may that individual continue with that method on or after January 1, 2003? Yes. For example, if a 50-year-old individual began receiving substantially equal periodic payments in 1999 using the fixed amortization method, the fixed stream of periodic payments may continue under that method.

10. If an individual begins receiving substantially equal period payments using a fixed method on or after January 1, 2003, may that individual change to the required minimum distribution method? Yes. If an individual begins receiving payments under either the fixed amortization method or the fixed annuitization method, that individual may change to the required minimum distribution method in a subsequent year. However, under Rev. Rul. 2002-62, once a change is made, that change must be followed in all subsequent years.

11. How are interest rates determined? The interest rate that may be used is any interest rate that is not more than 120% of the federal mid-term rate (determined in accordance with section 1274(d) of the Code for either of the two months immediately preceding the month in which the distribution begins). These interest rates are published by the Service in revenue rules; they are cumulatively available within the index of Applicable Federal Rules.

12. How is life expectancy determined? The life-expectancy tables that can be used are (1) the uniform life table in Appendix A of Rev. Rul. 2002-62, (2) the single life-expectancy table in §1.401(a)(9)-9, Q&A-1 of the income Tax Regulations or (3) the joint life and last survivor table in §1.401(a)(9)-9, Q&A-3 of the regulations.

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13. How is the account balance determined? The account balance may be determined in any reasonable manner that is used consistently.

14. How are annual, substantially equal periodic payments determined for purposes of the required minimum distribution method, the fixed amortization method and the fixed annuity method? An example of the required distribution method, an example of the fixed amortization method, and an example of the fixed annuity method using the methodologies described in Rev. Rul. 2002-62 are set forth.

Facts: Mr. B is the owner of an IRA from which he would like to start taking distributions beginning in 2003. Mr. B will celebrate his 50th birthday in January 2003. Mr. B would like to avoid the additional 10% tax imposed on early distributions under section 72(t)(1) by taking advantage of the exception in section 72(t)(2)(A)(iv) for distributions in the form of substantially equal periodic payments.

Assumptions: • the account balance of Mr. B's IRA is $400,000 as of December 31, 2002, and this is the account balance (and, when applicable, the date as of which the account balance is determined) used to calculate distributions. • 120% of the federal mid-term rate for the appropriate month is assumed to be 4.5% and, when applicable, this is the interest rate that will be used for calculations. • distributions will be over Mr. B's life only and, where applicable, single life expectancy will be used for calculations.

(1) Required minimum, distribution method. For 2003 the annual distribution amount ($11,695.91) is calculated by dividing the December 31, 2002, account balance ($400,000) by the single life expectancy (34.2) obtained from Q&A-1 of §1.401(a)(9)-9 of the Income Tax Regulations when an age of 50 is used. ($400,000/34.2 = $11,695.91) For subsequent years, the annual distribution amount will be calculated by dividing the account balance as of December 31 of the prior year by the single life expectancy obtained from the same single life expectancy table using the age attained in the year for which distributions are calculated. For example, if Mr. B's IRA account balance, after the 2003 distribution has been paid, is $408,304 on December 31, 2003, the annual distribution amount for 2004 ($12,261.38) is calculated by dividing the December 31, 2003 account balance ($408,304) by the single life expectancy (33.3) obtained from Q&A-1 of §1.401(a)(9)-9 of the Income Tax Regulations when an age of 51 is used. ($408,304/33.3 = $12,261.38)

(2) Fixed amortization method. For 2003, the annual distribution amount will be calculated by amortizing the account balance ($400,000) over a number of years equal to Mr. B's single life expectancy (34.2) (obtained from Q&A-1 of §1.401(a0(9)-9 of the Income Tax Regulations when an age of 50 is used), at a rate of interest equal to 4.5%. If an end-of-year payment is calculated, then the annual distribution amount in 2003 is $23,134.27. Once an annual distribution amount is calculated under this fixed method, the same amount will be distributed under the third method in subsequent years.

(3) Fixed annuitization method. Under this method the annual distribution amount for 2003 is equal to the account balance ($400,000) divided by the cost of an annuity factor that would provide one dollar per year over Mr. B's life, beginning at age 50 (i.e., the actuarial present value of an annuity of one dollar a year payable for the life of a 50 year old). The age 50 annuity factor (17.462) is calculated based on the mortality table in Appendix B of Rev. Rul. 2002-62 and an interest rate of 4.5%. Such calculations would normally be made by an actuary. The annual distribution is calculated as $400,000/17.462 = $22,906.88. Once an annual distribution amount is calculated under this fixed method, the same amount will be distributed under this method in subsequent years.

15. What is an example of a one-time change from a fixed amortization method to the required minimum distribution method? Facts and Assumptions: Mr. S started receiving distributions from this IRA in the form of annual substantially equal periodic payments in 1998 at age 50. His annual payment ($97,258) had been originally calculated using the amortization methodology, with the same amount distributed each year. Following a steep decline in his IRA account balance from $1,400,000 in 1998 to $750,000 in 2002, Mr. S would like to use the special rule allowing a one-time change to the required minimum distribution method provided in section 2.03(b) of Rev. Rul. 2002-62 to determine a new annual distribution amount for 2002. For this one-time change in method, Mr. S will determine an annual distribution amount for 2002 using this IRA account balance on September 30, 2002 ($750,000), and a single life expectancy of 30.5 (obtained from Q&A-1 of §1.401(a)(9)-0 of the Income Tax Regulations when an age of 54 is used). Under the new method, the annual distribution amount for 2002 is $24,590.16 ($750,000/30.5). Mr. S must use the required minimum distribution method to determine the annual distribution amount for subsequent years.

16. What is the effect of an account being completely depleted? If an individual's assets in an individual account plan or an IRA are depleted, the individual will not be subject to the income tax section 72(t)(1) of the Code as a result of not receiving substantially equal periodic payments. In addition, the recapture tax described in section 72(t)(4) of the Code will not be applicable.

17. Are the methods contained in Rev. Rul. 2002-62 the only acceptable methods of meeting section 72(t)(2)(A)(iv) of the Code? No. Another method may be used in a private letter ruling request, but, of course, it would be subject to individual analysis.

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ANALYZING IRA BENEFICIARY SITUATIONS AND OPTIONS BY EXAMINING VARIOUS EXAMPLES

When an IRA accountholder dies, your approach should be to first determine which situation applies and then apply the proper procedures. Here is a summary of the six (6) situations:

Death Occurs Before the Required Beginning Date

Situation #1: The spouse is the sole beneficiary;

Situation #3: The beneficiary is someone other than the spouse or the spouse is not the sole beneficiary; or

Situation #5: The beneficiary is a nonliving entity (church, etc.)

Death Occurs On or After the Required Beginning Date

Situation #2: The spouse is the sole beneficiary;

Situation #4: The beneficiary is someone other than the spouse or the spouse is not the sole beneficiary; or

Situation #6: The beneficiary is a nonliving entity (church, etc.)

These six situations will be illustrated by the following examples.

Example #1. John and Mary Hanson have been married for 45 years. In 2002, John is age 75 and Mary is age 77. Each has been designated as the sole beneficiary of each other's IRA. The balance in Mary's IRA as of 12-31-01 was $25,000. The balance in John's IRA as of 12-31-01 was $20,000. The new uniform lifetime table will be used to determine the distribution period for 2002. Her period is 21.2 and his period is 22.9.

Her 2002 RMD = $25,000/21.2 = 1,179.25

His 2002 RMD = $20,000/22.9 = 873.36

John died on October 11, 2002. No amount of the RMD from his IRA had been distributed to him prior to his death. And Mary had not yet been paid any of her RMD for 2002.

Mary will want to consider the following options with respect to John's IRA. John died after his required beginning date. This is Situation #2, since Mary is his sole beneficiary.

First, John's IRA is now an inherited IRA until Mary elects to treat it as her own. This happens automatically by John's death. We recommend the inherited or beneficiary IRA for Mary be set up as soon as possible. The account title should be—Mary Hanson as beneficiary of John Hanson's IRA.

(1) She will need to paid the RMD amount of $873.36 with respect to John's IRA on or before 12-31-02.

(2) If she does not elect to treat John's IRA as her own on or before 12-31-02, then the beneficiary RMD rules will apply to determine the RMD for 2003 and subsequent years. In 2003 Mary will be 78. Thus, her distribution period from the single life table will be 11.4, and it will be 10.8 for 2004 when she will be 79. When the spouse is the sole beneficiary, the single life table is referred to each year using that year's age.

Second, she may elect to treat John's IRA as her own in 2002 or any later year.

(1) Under the final regulation, the funds may be transferred immediately from his IRA into her IRA. The RMD amount of $873.36 with respect to his IRA will need to be paid to her on or before 12-31-02. It would be best if the IRA custodian reports this amount as a reason code "4" for Form 1099-R reporting purposes, but we believe the IRS would accept the reason code "7" also, as the 10% additional tax is not due in either situation.

(2) She will also need to be paid her RMD amount of $1,179.25 on or before 12-31-02.

(3) If she elects to treat John's IRA as her own on or before 12-31-02, then she will be able to use the uniform lifetime table to determine the distribution period for 2003 and subsequent calculations.

Example #2. The factual situation is the same as for Example #1, except John attains age 70 and 70 1/2 in 2002.

Mary's RMD amount remains $1,179.25.

John's RMD for 2002 is $729.93 ($20,000/27.4). However, because he died before his required beginning date (i.e. 4-1-03), there is no requirement that this amount be distributed to Mary. That is, the RMD amount for the year a person attains age 70 1/2 is only tentative and is not required to be paid out if the accountholder dies before his or her required beginning date.

This is Situation #1—since Mary is his sole beneficiary and John died before his required beginning date. Mary, as the sole spouse beneficiary, has the three options—life-distribution rule, five-year rule, or elect as own.

Remember that any beneficiary, including a sole beneficiary, is deemed to have elected the life-distribution rule unless he or she expressly elects the five-year rule. The starting date for the life-distribution rule will be 12-31-03 since he died during the year he attained age 70 1/2.

Example #3. The factual situation is the same as for Example #1, except John attains age 70 and 70 1/2 in 2002, and Mary (not John) dies on November 11, 2002.

This is Situation #2—since John is her sole beneficiary and Mary died after her required beginning date. John will have two options.

First, John will need to be paid Mary's RMD amount of $1,179.25 for 2002 on or before December 31, 2002.

Second, distributions for subsequent years will be based on John's single life expectancy as recalculated each year unless he would elect to treat the IRA as his own. If he elects to treat Mary's IRA as his own, he should do so on or before December 31 of any given year, he then will be able to use the uniform lifetime table to calculate the distribution period for subsequent years.

Third, he may elect to treat her IRA as his own. It is assumed he does so in 2002. Thus, he will be able to transfer her IRA

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into his. He will still need to be paid the RMD amount of $1,179.25 with respect to her IRA by December 31, 2002. John will also need to take his RMD amount on or before April 1, 2003, since he attained age 70 1/2 in 2002.

Example 4. Rita Marx is age 81 in 2002. She has designated her daughter, Barb Smith, age 44, as her sole beneficiary.

The balance in Rita's IRA as of 12-31-01 was $27,000. Her RMD amount for 2002 is $1,508.38 ($27,000/17.9). She died on November 8, 2002.

This is Situation #4. There is a nonspouse beneficiary, and the accountholder has died after her required beginning date. Barb is entitled to withdraw the RMD amount or an amount greater than the RMD, including a lump-sum distribution. For 2002, the RMD amount will have been determined using Rita's age and the uniform lifetime table. For subsequent years, the RMD amount will be based on Barb's single life expectancy. An initial distribution period will be determined for 2003 and then reduced by one for each subsequent year.

Example #5. The same factual situation as Example #4, except Rita Marx is age 53 and Barb Smith is age 24.

This is Situation #3. There is a nonspouse beneficiary and the accountholder has died before her required beginning date. Barb, as a nonspouse beneficiary, has the two options—the life-distribution rule or the five-year rule. Barb does not have the right to treat Rita's IRA as her own or to roll it over.

Remember that any beneficiary, including a sole beneficiary, is deemed to have elected the life-distribution rule unless he or she expressly elects the five-year rule. The starting date for the life-distribution rule will be 12-31-03, since Rita died during 2002. Barb is entitled to withdraw the RMD amount, or an amount greater than the RMD, including a lump-sum distribution. For 2003, the RMD amount will be based on Barb's single life expectancy. An initial distribution factor will be determined for 2003 and then reduced by one for each subsequent year.

Example #6. The same factual situation as Example #4, except Rita Marx's designated beneficiary is her estate rather than her daughter. Rita Marx is age 81 in 2002. The balance in her IRA as of 12-31-01 was $27,000.

The distribution period from the uniform lifetime table is 17.9. Her RMD amount for 2002 is $1,508.38. She died on November 8, 2002.

This is Situation #6. There is a nonspouse beneficiary, and the accountholder has died after her required beginning date. The estate is entitled to withdraw the RMD amount or an amount greater than the RMD, including a lump-sum distribution. For 2002, the RMD amount will have been determined using Rita's age and the uniform lifetime table. For subsequent years, the RMD amount will be based on Rita's single life expectancy. An initial distribution factor will be determined for 2002 (but not used for 2002, as the uniform lifetime factor is used) and then reduced by one for each subsequent year.

Example #7. The same factual situation as Example #5, except Rita Marx's designated beneficiary is her estate rather than her daughter. Rita Marx is age 53 in 2002. The balance in her IRA as of 12-31-01 was $27,000.

This is Situation #5. The estate is a nonspouse beneficiary, and the accountholder has died before her required beginning date. The life-distribution rule is not available in this situation. The estate will have to comply with the five-year rule.

Example #8. Sue and Tom Tipton have been married for 15 years. In 2002, Sue is age 53 and Tom is age 51. Tom's date of birth is 2-10-51. Each has been designated as the sole beneficiary of each other's IRA. Tom dies in December of 2002. The balance in Sue's IRA as of 12-31-01, was $18,000. The balance in Tom's IRA as of 12-31-01, was $50,000.

This is Situation #1, as Tom died before his required beginning date. Sue has the three options which a sole spouse beneficiary has—life-distribution rule, five-year rule and/or elect his IRA as her own IRA.

Does she want to treat his IRA as her own? Probably not if it is possible that Sue might wish to use some of the funds before she attains age 59 1/2, then she will not want to treat Tom's IRA as her own IRA. As long as the funds are withdrawn from an inherited or beneficiary IRA, then the 10% additional tax of Code section 72(t) will not be imposed. However, the tax would be imposed if she were to treat Tom's IRA as her own and then take a distribution.

Sue is considered to have elected the life-distribution rule unless she expressly elects one of the other two options. This periodic distribution over Sue's life expectancy must commence no later than December 31 of the year Tom would have attained age 70 1/2. This would be 12-31-21. She is permitted to commence distribution before 12-31-21. For this reason, most likely, she would not want to treat his IRA as her own, as the five-year period would be up before she attained age 59 1/2. Once she attains age 59 1/2, if she wished, she could elect to treat his IRA (i.e. the beneficiary IRA) as her own IRA.

Example #9. Mia and Rhett Meyer have been married for 10 years. In 2002 Rhett is age 49 and Mia is age 61. Rhett's date of birth is 3-11-41. Each has been designated by the other to receive 50% of their IRA funds, with the remaining 50% to go to a child from a prior marriage. Mia has designated her son to receive the other 50%. Rhett has designated his daughter Kathy to receive the other 50%. The balance in Mia's IRA as of 12-31-01 was $38,000. The balance in Rhett's IRA as of 12-31-01 was $72,000. Rhett dies in December of 2002. What options should Mia consider?

This is Situation #3. Mia is not the sole beneficiary, so she does not have the right to elect to treat Rhett's IRA as her own IRA. She will want to use the life-distribution rule unless she is supremely confident that she will not to withdraw any of the funds until after she is age 59 1/2. If so, she could treat it as her

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own IRA. Even if the life-distribution rule applies, she would have the right to roll over the funds paid from the beneficiary IRA.

What options should Kathy consider? She has only the two options—the life-distribution rule and the five-year rule.

Kathy is considered to have elected the life-distribution rule unless she expressly elects one of the other two options. This periodic distribution over Kathy's life expectancy must commence no later than December 31 of the year Rhett would have attained age 70 1/2. This would be 12-31-21. She is permitted to commence distribution before 12-31-21. For this reason, most likely, she would not want to treat his IRA as her own as the five year period would be up before she attained age 59 1/2. Once she attains age 59 1/2, if she wished, she could elect to treat his IRA (i.e. the beneficiary IRA) as her own IRA.

Example #10. Doris Cisco had an IRA with a balance of $45,000 as of 12-31-96. Her date of birth is 6-16-32. She had designated her husband, Walter, as her sole primary beneficiary. Doris died on 1-4-97. Walter's date of birth is 9-9-20.

This is Situation #1, as Doris died before her required beginning date. Walter had the three options. In 1997, he elected the life-distribution rule rather than electing to treat Doris' IRA as his own because this allowed him to postpone distribution to December 31, 2002, the year she would have attained age 70 1/2. If he had elected to treat it as his own, then he would have been required to commence RMD distributions with respect to this amount.

Is he eligible, in 2002, to treat this IRA as his own even though he elected the life-distribution rule in 1997? We believe he is. Q&A-5 of Regulation 1.408-8 permits this election to be made at any time after the individual's date of death. We believe the RMD amount for 2002 which will need to be paid to him on or before 12-31-02.

Query: would any RMD be required if he had elected to treat her IRA as his own in 2001 (i.e. the year before the year she would have attained age 70 1/2)? We don't think so.

Summary. We have set forth above how we suggest an IRA custodian analyze a "beneficiary" situation. Your first step is to determine which of six possible situations you are dealing with. Your second step is then to apply the applicable rules for that distribution.

TAX BASICS FOR INHERITED/BENEFICIARY IRAs—WHAT MOST IRA SOFTWARE VENDORS HAVEN'T FIGURED OUT

Background. An inherited IRA (or beneficiary IRA) must be administered differently than the IRAs for living accountholders. There are numerous reasons why this is so. First, a beneficiary IRA is not allowed to accept additional contributions, and a nonspouse beneficiary is not eligible to roll over a distribution from a beneficiary IRA. Second, the required distribution rules always apply to an inherited IRA. Third, the beneficiary steps into the deceased taxpayer's shoes and assumes the tax rights which the deceased accountholder had in the IRA, with one exception. The IRA distribution will be included in the income of the beneficiary (and not the deceased accountholder), and the beneficiary will have to pay the taxes on such distribution at his or her marginal tax rate.

As a result of the above special rules, an IRA owner (either as the living accountholder or because he or she took over the ownership from a deceased IRA accountholder) must be able to identify the source of each IRA he or she owns for purposes of figuring the taxation of a distribution from an IRA.

For discussion purposes, we will assume that Sara Dunlap has four personal IRAs as follows:

IRA #1 at Bank #1 with a balance of $12,000;

IRA #2 at Bank #1 with a balance of $36,000;

IRA #3 at Brokerage Firm #1 with a balance of $15,000; and

IRA #4 at Bank #2 with a balance of $8,000.

She has no basis within these four IRAs as she has never made a nondeductible contribution to a traditional IRA nor has she rolled over any after-tax contributions from a 401(k) plan.

She has also inherited two beneficiary IRAs from her dad.

IRA #5 at Bank #1 with a balance of $18,000; and

IRA #6 at Bank #3 with a balance of $12,000.

Her dad had made nondeductible contributions to his IRA to the extent of $6,000. Since her dad had not yet taken any distributions from his IRA, he still had this basis of $6,000. She now assumes the basis which he had. When she takes a distribution from one of his IRAs, she will calculate the amount of the distribution which she must include in her income by completing a Form 8606 which will reflect the information and transactions with respect to her dad's two IRAs. It will not reflect any of the information for her personal IRAs and the IRA she inherited from her mother. She has also inherited a beneficiary IRA from her mother. It is at Bank #1 also and has a balance of $20,000. Her mother had made nondeductible contributions to her IRA to the extent of $4,000. Since her mom

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Tax Basics for Inherited/Beneficiary IRAs,
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had not yet taken any distributions from her IRA, she still had this basis of $6,000. Sara now assumes the basis which her mother had. When Sara takes a distribution from her mother's IRA, she will calculate the amount of the distribution which she must include in her income by completing the Form 8606. She now assumes the basis which her mother had. When she takes a distribution from this inherited IRA, she will calculate the amount of the distribution which she must include in her income by completing a Form 8606 which will reflect the information and transactions with respect to her mom's IRA. It will not reflect any of the information for her personal IRAs and the two IRAs she inherited from her father.

The IRA Custodian's Reporting Duties and the Software Vendor's Duties

A software vendor should be able to give an IRA custodian the capability to do what the IRS has stated is required. The cardinal IRS reporting rule is that the reporting forms, Form 5498 and Form 1099-R, are required to be prepared on a per-IRA plan agreement basis. However, many software vendors choose to ignore this rule. It is quite common in the IRA data processing industry that the software will prepare just one Form 5498 or Form 1099-R for a person on a per-social-security number basis. Preparing just one Form 5498 or Form 1099-R when more are required will subject the IRA custodian to possible fines of $50 per account and possible claims by the beneficiary for having to correct tax returns.

In the above example, there are seven different plan agreements, and she will need to receive a reporting form for each one of them. For example, Bank #1 is not allowed to aggregate the four IRAs which Sara has at the bank—two of her own personal IRAs, one of the IRAs she acquired from her father and the one she acquired from her mother.

In summary, there will be reporting forms (Form 5498 and Form 1099-R) for each of the seven IRAs. In the case of her four personal IRAs, the IRA custodian will want to show the recipient of the Form 5498 as "Sara Dunlap" and the recipient of the Form 1099-R as "Sara Dunlap." In the case of the two IRAs which she acquired from her dad, the IRA custodian will want to show the recipient of the Form 5498 as "Sara Dunlap as Beneficiary of Father Dunlap's IRA" and the recipient of the Form 1099-R as "Sara Dunlap as Beneficiary of Father Dunlap's IRA." With respect to the Form 5498, the IRS has made this very clear. With respect to the Form 1099-R, the IRS has not made it clear that they want the decedent's name referenced, but they do. It should be added if it is not included. In the case of the IRA which she acquired from her mother, the IRA custodian will want to show the recipient of the Form 5498 as "Sara Dunlap as Beneficiary of Mother Dunlap's IRA" and the recipient of the Form 1099-R as "Sara Dunlap as Beneficiary of Mother Dunlap's IRA" for the reasons just discussed.

Income Tax Calculations by the Taxpayer

The taxpayer (Sara Dunlap) is responsible to reflect the tax consequences of any distributions which she receives from any one or more of her seven IRAs—four personal and three inherited. The IRA custodian is obviously not responsible.

As indicated above, for income tax calculation purposes, Sara will have three different IRAs, as she is not allowed to aggregate all seven IRAs. She will have one calculation for her four personal IRAs, as she is required to aggregate them. She will have one calculation for the two IRAs she acquired from her father, as she is required to aggregate these IRAs. She will have one calculation for the IRA she acquired from her mother.

For beneficiary RMD purposes, she is required to do a separate RMD calculation for each of her seven IRAs, but she is allowed to aggregate the RMD amounts and withdraw the total RMD from just one of the IRAs. For years prior to 2002, she was allowed to aggregate her personal IRAs with the inherited IRAs. Commencing in 2003, a taxpayer will not be allowed to aggregate his or her personal IRAs with any IRAs which he or she owns as a beneficiary unless such IRAs were inherited or acquired from the same decedent. Only like-kind IRAs may be aggregated for RMD calculation purposes, and Inherited IRAs are like-kind only if inherited or acquired from the same decedent.

IRS Issues 2003 COLAs

IRS Announces Cost-of-Living Adjustments for 2003
The IRS in News Release 2002-111 Released its 2003 Adjustments as Follows:

	2001	2002	2003
Taxable Wage Base — OASDA Only	$80,400	$84,900	$87,000
SEP and Qualified Plan Maximum Compensation Cap – 401(a)(17) & 404(e)	$170,000	$200,000	$200,000
Elective (Salary) Deferral Limit – 401(k) & SAR-SEP	$10,500	$11,000	$12,000
Elective Deferral Catch-up Limit	N/A	$1,000	$2,000
SIMPLE Deferral Limit – 408(p)(2)(A)	$6,500	$7,000	$8,000
SIMPLE Catch-up Limit	N/A	$500	$1,000
Highly-Compensated Employees (Compensation as Indexed) New Definition as of January 1, 1997	$85,000	$90,000	$90,000
Defined Benefit Limit – Section 415(b)(1)(A)	$140,000	$160,000	$160,000
Defined Contribution Limit – Section 415(c)(1)(A)	$35,000	$40,000	$40,000
SEP Minimum Compensation Threshold – 408(k)(2)(c)	$450	$450	$450