

TRANSFERRING IRA/QUALIFIED PLANS - - FIVE COSTLY MISTAKES - -

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On April 17, 2002, the Treasury Department issued streamlined, final regulations controlling minimum distributions from IRAs and qualified retirement plans.¹ These final rules are a refreshing relief from the oppressive temporary regulations that controlled since 1986. The new rules eliminate confusing and irrevocable elections at age 70½, as well as overly-complicated distribution choices.

As of 2003, all IRA owners and qualified plan participants must use the new rules to determine their minimum required distributions (“MRDs”) - - even those who began distributions years ago. In fact, even the designated beneficiaries as well as distribution amounts must be redetermined for those who died before 2003.²

Most of us will take lifetime MRDs using a single Uniform Lifetime Table when we reach the “required beginning date”, which is almost always April 1 of the year after we turn 70½.³

UNIFORM LIFETIME TABLE							
Age	Factor	Age	Factor	Age	Factor	Age	Factor
70	27.4	82	17.1	94	9.1	106	4.2
71	26.5	83	16.3	95	8.6	107	3.9
72	25.6	84	15.5	96	8.1	108	3.7
73	24.7	85	14.8	97	7.6	109	3.4
74	23.8	86	14.1	98	7.1	110	3.1
75	22.9	87	13.4	99	6.7	111	2.9
76	22.0	88	12.7	100	6.3	112	2.6
77	21.2	89	12.0	101	5.9	113	2.4
78	20.3	90	11.4	102	5.5	114	2.1
79	19.5	91	10.8	103	5.2	115+	1.9
80	18.7	92	10.2	104	4.9		
81	17.9	93	9.6	105	4.5		

Using the Uniform Table is a piece of cake. Simply obtain the year-end balance of your retirement account from last year, and divide that balance by the factor in the Uniform Table that matches your age on your birthday this year.⁴

Example: If you turn 73 sometime this year, your factor for 2003 is 24.7. You divide your \$500,000 IRA (balance as of 12/31/02) by 24.7, and your MRD is \$20,243.

The Uniform Table is economically generous enough that if one simply takes the MRD each year from even a modestly appreciating IRA, the IRA is almost certain to last throughout the owner's lifetime as well as over the lives of a surviving spouse and/or children. For example, if a 70-year-old owns a \$1 million IRA growing at 6% per year, and the owner takes only the MRD each year, the account will continue to increase until the owner hits age 82 and will not drop below \$1 million until the owner reaches age 91. So, benefits undoubtedly will remain for beneficiaries.

Despite the welcome simplification and economic improvements offered by the final regulations, those attempting to apply them can be lulled into distribution errors. This article selects five costly mistakes made in applying the 2002 minimum distribution rules and suggests techniques to avoid them.

Costly Error #1 - - Losing the Stretch.

While the economically beneficial final rules almost guarantee that an owner's IRA will last a second generation, obtaining this stretch can only be accomplished by (i) naming a living, breathing individual to inherit the IRA, (ii) who actually takes distributions over his/her lifetime.

All beneficiaries who inherit IRAs take distributions using the Single Life Table.⁵

SINGLE LIFE EXPECTANCY (For Use by Beneficiaries)					
Life		Life		Life	
Age	Expectancy	Age	Expectancy	Age	Expectancy
0	82.4	37	46.5	74	14.1
1	81.6	38	45.6	75	13.4
2	80.6	39	44.6	76	12.7
3	79.7	40	43.6	77	12.1
4	78.7	41	42.7	78	11.4
5	77.7	42	41.7	79	10.8
6	76.7	43	40.7	80	10.2
7	75.8	44	39.8	81	9.7
8	74.8	45	38.8	82	9.1
9	73.8	46	37.9	83	8.6
10	72.8	47	37.0	84	8.1
11	71.8	48	36.0	85	7.6
12	70.8	49	35.1	86	7.1
13	69.9	50	34.2	87	6.7
14	68.9	51	33.3	88	6.3
15	67.9	52	32.3	89	5.9
16	66.9	53	31.4	90	5.5
17	66.0	54	30.5	91	5.2
18	65.0	55	29.6	92	4.9
19	64.0	56	28.7	93	4.6
20	63.0	57	27.9	94	4.3
21	62.1	58	27.0	95	4.1
22	61.1	59	26.1	96	3.8
23	60.1	60	25.2	97	3.6
24	59.1	61	24.4	98	3.4
25	58.2	62	23.5	99	3.1
26	57.2	63	22.7	100	2.9
27	56.2	64	21.8	101	2.7
28	55.3	65	21.0	102	2.5
29	54.3	66	20.2	103	2.3
30	53.3	67	19.4	104	2.1
31	52.4	68	18.6	105	1.9
32	51.4	69	17.8	106	1.7
33	50.4	70	17.0	107	1.5
34	49.4	71	16.3	108	1.4
35	48.5	72	15.5	109	1.2
36	47.5	73	14.8	110	1.1

		111	1.0
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To use: The beneficiary finds his/her age for the year after the owner's death and takes an MRD using the factor beside that age.

Example: Sue is 37 the year after her mother dies. Sue divides the mother's IRA balance that she inherited by 46.5.

A non-spouse simply drops the factor by 1 each succeeding year (45.5, 44.5, 43.5, etc.) and divides the prior year-end IRA balance by the new factor. This is a **fixed** withdrawal.

In contrast, spouse's **recalculate** or go back to the chart each year for a new factor. The factor does not drop by one whole number each year, which means greater deferral and stretch. The spouse though cannot recalculate if the IRA is left in a credit or QTIP trust.

Owners jeopardize a stretch by:

- forgetting to name beneficiaries
- forgetting to change a beneficiary who dies
- using trusts unnecessarily
- letting their benefits pass to their estates

Designated beneficiaries must be actual, living individuals.⁶ Estates, charities, partnerships, corporations and dead persons do not qualify for designated beneficiary

status.⁷ If one names such a beneficiary, the IRA at death is distributed much more quickly and at a tremendous loss in growth.

Trusts can be beneficiaries, but the new rules require extreme care in arranging a proper trust for beneficiary status.⁸ Even if the trust qualifies for individual beneficiary status, the possibility that trust assets could pass to older contingent beneficiaries will result in loss of stretch.⁹

Beneficiaries themselves jeopardize the stretch by seeking an immediate, total distribution of an inherited IRA without any awareness of the benefits they sacrifice. As shown on the table below, a 30-year old beneficiary who takes only MRDs from a \$500,000 inherited IRA ultimately will receive \$3.4 million (assuming 6% growth). In contrast, if the beneficiary withdraws the entire \$500,000 immediately upon inheriting it, the beneficiary pays about 40% in total income taxes and walks away with only \$300,000.

Total Stretch of Inherited IRA Non-Spouse Beneficiary - - 6% Growth

Age Inherit IRA	Life Expectancy	Inherited IRA \$100,000	Inherited IRA \$500,000	Inherited IRA \$1 Million
20	63.0	\$2,566,328	\$5,161,648	\$10,323,296
30	53.3	\$680,828	\$3,404,139	\$6,808,278
40	43.6	\$456,869	\$2,284,343	\$4,568,686
50	34.2	\$316,394	\$1,581,968	\$3,163,936

Beneficiaries, without good guidance, also re-title inherited IRAs in their own names, which subjects the IRA to full tax immediately. An inherited IRA must stay in the name of the decedent for distribution purposes.

Costly Mistake #2 -- Short Changing the Surviving Spouse.

A spouse is a favored beneficiary for retirement benefits. During the IRA owner's life, if the spouse is more than ten years younger, the owner's lifetime distributions are

based on a joint life table rather than the Uniform Table, resulting in even smaller MRDs.¹⁰

Upon the owner's death, the benefits will qualify for a marital deduction as well as generous income tax deferral options, but only if the surviving spouse is the **sole** beneficiary with unlimited withdrawal rights. Under the final regulations, a surviving spouse has options regarding the deceased spouse's IRA that generally are much more favorable than the options granted to other beneficiaries:

(1) **Rolling Over** - A spouse can roll over the benefits from the deceased owner's IRA into the spouse's own IRA.¹¹ A rollover gives the surviving spouse a powerful option to defer income taxes, not available to other beneficiaries.

- After a rollover, the spouse can designate her own beneficiaries. That way, the IRA that lasted for the life of the owner also can last for the life of the inheriting spouse, and then the life of the new beneficiary.
- If the surviving spouse is under age 70½, she can continue to contribute to the IRA and postpone distributions until 70½ - - allowing even more tax deferral and growth.
- By rolling over, the spouse can take her MRDs using the favorable Uniform Table - - an option never available to other beneficiaries.

(2) **Remaining as Beneficiary** – Perhaps a surviving spouse is under age 59½, the age when she can tap into her own IRA without penalty, and needs distributions from the inherited IRA now. Rather than rolling over the IRA, the surviving spouse can remain as beneficiary and still receive favorable treatment.¹² The surviving spouse can receive benefits by recalculating her life expectancy, a withdrawal method that encourages growth. No other beneficiary can use recalculation. Only at her death

must her beneficiaries convert to the fixed method and receive benefits over her remaining life expectancy.¹³

(3) Electing to Treat as Own – The surviving spouse can elect to treat her deceased husband's IRA as her own.¹⁴ This is, in essence, a roll over without the need to complete the application process for a new IRA.

Generally, to make any of these elections, the spouse must be the sole beneficiary of the IRA and have unlimited withdrawal rights. This requirement is not satisfied if a trust is named as beneficiary. Consequently, owners who choose to leave their retirement benefits to a credit trust or a QTIP trust are choosing to accelerate distributions at the cost of significant stretch.

Costly Mistake #3 - - Not Creating Separate Accounts.

Under normal circumstances, if an IRA owner names a group of individuals (children, grandchildren) to receive retirement benefits, the life expectancy of the oldest of the group is used for distributions to the entire group.¹⁵ If some of the beneficiaries are much younger, this use of the older beneficiary's life expectancy imposes a swifter distribution.

Example: Joe leaves his \$1 million IRA equally to his sister (age 60) and his son (age 30). The IRA is distributed over the sister's 25.2 year life expectancy rather than the son's 53.3 year life expectancy.

The final rules allow an exception where separate accounts are created. A separate account is an account that contains a portion of the owner's IRA benefits, including a pro-rata share of investment gains and losses, and contributions and forfeitures.¹⁶ Using the above example, Joe could split his IRA into two separate accounts before he dies, with one account or IRA for his sister and one for his son.

Then, at Joe's death, each separate account will pay out over each beneficiary's own life expectancy. The son gains 28 years of additional tax deferral and growth because of separate account treatment.

Some owners do not want the hassle of managing separate IRAs or accounts, and would rather have one IRA. The owner hopes that the IRA will be split among his multiple beneficiaries when they inherit it. For separate accounts after the owner's death, the beneficiary designation form must provide for fractional (1/3, 1/3, 1/3) or percentage (50% & 50%) interests.¹⁷ A pecuniary bequest (\$10,0000) does not fall within the definition for separate account treatment.

The new rules permit separation into separate accounts by the end of the year following the year of death.¹⁸ However, the safest rule is to separate by September 30th of the year following death because life expectancy payouts are determined by that date.

Also, for each individual trust beneficiary to utilize his or her own life expectancy for determining MRDs, separate accounts must be established in the IRA owner's beneficiary designation form **and** in the trust document. If separate shares are created in the trust document, but not in the beneficiary form, separate share treatment will not be allowed.¹⁹

Costly Mistake #4 - - Forgetting the IRD Deduction.

For death tax purposes, the gross estate of a decedent who dies owning an IRA or qualified plan includes the entire value of this "income in respect of a decedent".²⁰ As additional insult, these IRAs and qualified plans do not receive a step-up in basis at death.²¹ So, all the built in and deferred income tax is owing. As outrageous as it may sound, a \$1 million IRA could be hit with nearly 50% in death taxes, and then another

40% in federal and state income taxes, wiping out almost entirely the account at the owner's death.

In a rare extension of sympathy to those who must pay both estate tax and income tax on a single asset, the IRS permits beneficiaries of IRAs to take a deduction for the estate tax attributable to the IRA. This is called the IRC § 691(c) deduction.²² The deduction softens the overall tax erosion, but only for those beneficiaries who know about the deduction and then claim it each year they take an IRA distribution. Here are the deduction rules:

- The IRD deduction is permitted only if the estate paid federal estate tax.
- Figure the estate tax two ways: (1) with the value of the IRA included in the estate, and (2) without including the IRA. The difference in tax equals the IRD deduction for the IRA.
- Each year an IRA distribution is received, the beneficiary receives a proportionate share of the IRD deduction.

As an example, an IRA owner dies in 2002 with a \$2 million taxable estate that includes a \$1 million IRA. The estate tax with the IRA is \$500,000, and the estate tax without the IRA is zero. So, the IRD deduction is \$500,000. If a beneficiary withdraws \$100,000 or 10% of the IRA this year, he can claim 10% of the IRD deduction for this year.

The 691(c) deduction is not always fair in that it does not necessarily belong to the person who paid the estate tax.

Example: Fred dies with \$2 million of assets. \$1 million is in an investment account and passes to his son Jim. The other \$1 million is in an IRA that passes to his son Fred Jr. The estate (Jim's share) pays \$500,000 in federal estate tax on the \$2 million estate. As Fred Jr. takes distributions from his father's IRA, he receives the IRD deduction, even though

the estate tax came from Jim's share of the estate.

Costly Mistake No. 5 - - Failing to Roll Your Qualified Plan Into an IRA.

Staying in a qualified plan after you retire can be lousy if you wish to name a non-spouse beneficiary or a trust for death benefits. Most qualified plans do not allow such beneficiaries to receive distributions over a life expectancy. Instead, the beneficiary must receive the entire plan balance shortly after the owner's death, resulting in loss of important tax deferral, and immediate imposition of income taxes. No rollover rights exist for such non-spouses.

In contrast, IRAs offer flexibility to create stretch for non-spouse beneficiaries. You cannot leave qualified plan benefits to trusts without immediately prompting the necessity to pay income taxes, but you can IRAs. IRAs also offer the option of splitting accounts and naming primary and contingent beneficiaries of your choice.

Qualified plans are subject to federal law, which requires you to name your spouse as your beneficiary unless your spouse signs a waiver.²³ Consequently, use of trusts for benefits in second marriages is almost impossible. If the spouse does sign the waiver, the plan funds still are paid to the trust in full immediately after the death of the owner, and the trust pays the 40% tax.

Employees who hold highly appreciated employee stock in a plan definitely should consider a lump-sum distribution of their plan to take advantage of the "net unrealized appreciation" (NUA) tax break. The employee withdraws the entire plan upon separation from employment, rolls over the non-employee stock portion into an IRA, and places the stock in a regular investment account. The employee pays income tax only on the original cost of the stock. Later, when the employee sells the stock, the employee pays the capital gains rate on the appreciation.

Conclusion. – Costly mistakes can easily be avoided to enjoy the welcome tax deferral benefits provided by the new 2002 minimum distribution rules.

ENDNOTES

¹ 26 CFR Parts 1, 54 and 602, TD 8987, RIN 1545-AY69, 1545-AY70, revising the 2001 Prop. Regs. The final regulations are located at Reg. §1.401(a)(9)-0 through §1.401(a)(9)-5; §1.401(a)(9)-7 through §1.401(a)(9)-9; §1.403(b)-3; §1.408-8; and §54.4974-2.

² Preamble to 2002 regulations; Reg. §1.401(a)(9)-1, A-2(b).

³ Reg. §1.401(a)(9)-9, A-2; those married to a spouse more than 10 years younger use a more favorable joint life table; Reg. §1.401(a)(9)-9, A-3.

⁴ Reg. §1.401(a)(9)-5, A-1 through A-4.

⁵ Reg. §1.401(a)(9)-9, A-1.

⁶ Reg. §1.401(a)(9)-4, A-1 and A-4(a); the beneficiary is named by the Participant on a form provided, or by a default provision in the plan or IRA document naming a specific individual (e.g., spouse or children); Reg. §1.401(a)(9)-4, A-1 and A-2.

⁷ Reg. §1.401(a)(9)-4, A-3. This is so even though the Participant's interest in the IRA may pass from the estate to identifiable individuals under state law; PLR 2001-26041.

⁸ Reg. §1.401(a)(9)-4, A-5 and A-6.

⁹ Reg. §1.401(a)(9)-5, A-7(b) and (c); LTR 2002-28025 (April 18, 2002).

¹⁰ Reg. §1.401(a)(9)-5, A-4(b); §1.401(a)(9)-9, A-3.

¹¹ A spouse's right to roll over non-required distributions she receives from her deceased spouse is not part of the "minimum distribution rules," but is provided by statute (IRC §408(d)(3)(c) for IRAs and IRC §402(c)(9) for qualified plans). Therefore, she can make this election at any time after the owner's death.

¹² Reg. §1.401(a)(9)-3, A-3(b)(1) and (b)(2).

¹³ Reg. §1.401(a)(9)-5, A-5(c)(2).

¹⁴ Reg. §51.408-8, A-5(a).

¹⁵ Reg. §1.401(a)(9)-5, A-7.

¹⁶ Reg. §1.401(a)(9)-8, A-3.

¹⁷ This requirement comes from the definition of separate accounts: "Separate accounts in an employee's account are separate portions of an employee's benefit reflecting the separate interests of the employee's beneficiaries under the plan as of the date of the employee's death for which separate accounting is maintained." Id.

¹⁸ Reg. §1.401(a)(9)-8, A-2(a)(2); PLR 2002-28025; PLR 2002-35038 – 2002-35041.

¹⁹ See PLRs 2003-17044, 2003-17043, and 2003-17041.

²⁰ Rev. Rul. 92-47, 1992-1(C.B.)198, TAM 2002-47001 (rejecting a discount for the income tax or lack of marketability of an IRA included in an estate).

²¹ IRC §1014(c).

²² IRC §691(c).

²³ Retirement Equity Act of 1984; IRC §401(a)(11) and §417; ERISA §205.