

# Required Minimum Distributions and Stretching

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**W**hile numerous benefits derive from saving for retirement using IRAs and Qualified Plans, one of the more significant is tax deferral. Money inside an IRA or Qualified Plan is not subject to income tax until it is distributed from the plan (IRC §402). For an example of how this works, assume that an IRA with a beginning balance of \$1 million accumulates tax deferred at a 10% rate of return for 20 years. With no further contributions, the IRA will grow under such conditions to \$6,727,500. However, if the IRA is taxed at 29% as it grows, the end result is \$4,222,590. Because of the effect of tax deferral, you would keep your money invested in IRAs indefinitely if you could. However, the Government never intended to wait forever to tax your money. So Congress passed rules to serve the Government's interest. In general terms, these rules govern when and how funds must be distributed from IRAs and Qualified Plans.

## **WHEN THE MONEY MUST START COMING OUT – REQUIRED BEGINNING DATE (RBD)**

When the money must begin coming out of an IRA or Qualified Plan depends on the type of IRA or Qualified Plan. As a general rule, funds must begin coming out of the IRA or Qualified Plan by April 1st of the year after the participant turns age 70½. Unless the IRA custodial agreement or Plan Agreement provides otherwise, follow the distribution rules in the chart at the end of this chapter (Treas. Reg. §1.401(a)(9)-4).

If withdrawals do not begin by the RBD, a penalty equal to 50% of the amount that should have been withdrawn, but wasn't, will be incurred. Keep in mind that the RBD date is mandatory date by which the plan participant/IRA owner must begin withdrawing from the account. This does not mean withdrawals cannot occur earlier. In fact, withdrawals can occur as early as the plan participant/IRA owner turning age 59½. Withdrawals occurring prior to age 59½ will be penalized at 10% on the amount withdrawn.

## **HOW THE MONEY MUST COME OUT – REQUIRED MINIMUM DISTRIBUTIONS (RMDS)**

Required Minimum Distributions are the annual amounts the plan participant/IRA owner must withdraw from the Qualified Plan or IRA to avoid penalty. The

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RMD rules apply to all Qualified Plans, IRAs (including Roth IRAs held by beneficiaries), Deferred Compensation Plans, and IRC section 403(b) plans. RMDs are a function of two variables:

1. The maximum period over which distributions can occur without penalty; and
2. The amount of money in the plan or account.

## **MAXIMUM DISTRIBUTION PERIOD – LIFE EXPECTANCY**

The longest period over which distributions can occur without penalty is the life expectancy of the Qualified Plan or IRA beneficiary. Life expectancies are set by Tables published by the IRS. See Treas. Reg. §1.401(a)(9)-9. Three tables are published:

1. Single Life Table — used for determining the life expectancy of a single individual;
2. Uniform Life Table — sets forth the life expectancy of a married plan participant or IRA owner whose spouse is not more than 10 years younger than he or she is; and
3. Joint and Last Survivor Table — provides the life expectancy of a plan participant or IRA owner whose spouse is more than 10 years younger than he or she is.

As long as the plan participant or IRA owner is alive, determining life expectancy is straightforward. One simply goes to the appropriate table and finds his or her age in the year the distribution is to occur and selects his or her life expectancy from the Table. Things get more complicated if the plan participant/IRA owner dies before his or her interest in the Qualified Plan or IRA is entirely distributed. In such a case, the maximum distribution period will depend on whether the plan participant/IRA owner died before or after the required beginning date and whether he or she named a designated beneficiary for the remainder of the interest.

### **Life Expectancy if Death Occurs Prior to Required Beginning Date**

The maximum distribution period if the plan participant/IRA owner dies before reaching age 70½ depends on whether a Designated Beneficiary was named to receive the balance of the interest. For these purposes, the term “Designated Beneficiary” is a term of art.

Under IRC §401(a)(9)(E) and the regulations thereunder, Designated Beneficiaries are only *individuals* who are entitled to a portion of the plan participant or IRA owner’s benefit upon the death of the participant/owner, or other specified event. In some cases, a properly crafted trust will qualify as a Designated Beneficiary. If anyone other than an individual or a qualified trust is named as a beneficiary, the participant/owner will be treated as having no Designated Beneficiary, even if individuals are also named.

In the absence of Qualified Plan or IRA provisions to the contrary, the balance of the plan participant/IRA owner's interest can be distributed over the Designated Beneficiary's life expectancy if death occurs prior to the Required Beginning Date. If there are multiple Designated Beneficiaries, the shortest life expectancy (that is, the life expectancy of the oldest beneficiary) is used in the absence of separate accounts.

If there is no Designated Beneficiary, the balance of the plan participant/IRA owner's interest must be distributed in full by December 31 of the fifth year after his or her death. This is commonly referred to as the Five Year Rule.

Whether a life expectancy or the Five Year Rule is used, RMDs must begin by December 31 of the year after the plan participant/IRA owner dies. Surviving spouses receive special consideration. When spouses are named as Designated Beneficiaries, they have a choice: 1) they may defer taking RMDs until December 31 of the year the plan participant/IRA owner would have turned 70½; or 2) they may follow the general rule and begin taking RMDs by no later than December 31 the year after the plan participant/IRA owner died.

### **Life Expectancy if Death Occurs After Required Beginning Date**

If the plan participant/IRA owner dies after his or her required beginning date, the maximum period over which the remaining balance can be distributed, will again, depend on whether there is a Designated Beneficiary. If there is a Designated Beneficiary, distributions can occur over the life expectancy of: 1) the plan participant/IRA owner; or 2) the Designated Beneficiary, whichever is longer. If a Designated Beneficiary is not named, distributions may occur over the theoretical life expectancy of the plan participant/IRA owner for his or her age as of the year he or she died had he or she lived. For obvious reasons, this is commonly referred to as the "Ghost Life Expectancy."

## **MINIMIZING RMDs – THE STRETCH**

The power behind Qualified Plans and IRAs is tax deferral. For this reason, plan participants/IRA owners would leave the money in the Qualified Plan/IRA forever if they could. However, the government wants its due and has promulgated rules that force the money out from under the umbrella of tax deferral. Carefully applied, however, the rules allow us stretch distributions over a period of time, thereby preserving the tax deferral (at least for a while). The key to preserving tax deferral then is to maximize the stretch afforded by the rules; the key to maximizing the stretch is the Inherited IRA.

## **THE INHERITED QUALIFIED PLAN/IRA**

Just like the term "Designated Beneficiary," the phrase "Inherited Qualified Plan/Inherited IRA" is a term of art. A Qualified Plan or IRA is inherited if the person for whom it is maintained acquired his or her interest because of the death of the

original owner. Two key elements make this work. The first is the beneficiary designation form.

The beneficiary designation form is provided to the original owner by the plan administrator/IRA custodian and is used to name who will receive what remains of the original owner's interest when he or she dies. In other words, the form names the Designated Beneficiary. The trick to the beneficiary designation form is to ensure it is completed before the original owner dies and that it names only beneficiaries who qualify as Designated Beneficiaries. In a perfect world, these forms are drafted by legal counsel. Why? Because it is the beneficiary designation form and not the will, trust, or other estate planning document that controls the disposition of the plan/IRA interest upon the original owner's death. Therefore, to achieve the original owner's estate planning goals, the beneficiary designation form must be consistent with the architecture of the overall estate plan. The second key to Inherited Qualified Plans/IRAs is how the interest is titled after the death of the original owner.

In the world of Inherited Qualified Plans/IRAs, re-titling what remains of the original owner's interest in the name of beneficiaries is fatal. Doing so is deemed a lump-sum distribution to the named beneficiaries. If the interest is deemed distributed in its entirety, it is not possible to distribute it over a beneficiary's life expectancy, so the stretch is destroyed. The proper way to retitle a Qualified Plan/IRA after the death of the original owner is essentially "John Doe, deceased (09/01/08), FBO Fawn Doe, beneficiary."

### **Spouse as Designated Beneficiary**

Surviving spouses receive preferential treatment if named as Designated Beneficiary of an Inherited Qualified Plan/IRA. First, they can elect to defer taking RMDs until the original owner would have reached 70½. Second, they can use a method of determining life expectancy that recalculates life expectancy each distribution year. Most important, however, is the surviving spouse's ability to roll the Inherited Qualified Plan/IRA into his or her own Qualified Plan/IRA. This is commonly referred to as the "Spousal Rollover." The Spousal Rollover is available only to surviving spouse Designated Beneficiaries.

As with most options, there is an upside and a downside to Spousal Rollovers. On the upside, by rolling over an Inherited Qualified Plan/IRA, the new account is treated as the surviving spouse's own account, subjecting the surviving spouse to all the "normal" rules applicable to an account owner and entitling the surviving spouse to all the rights and incidents of ownership, including the right to name beneficiaries. On the downside, if a spouse is younger than 59½, he or she won't be able to get to the money without incurring the 10% early withdrawal penalty. This is commonly known as the "Spousal Rollover Trap."

Another consideration is who will receive the funds remaining upon the death of the surviving spouse and how those beneficiaries will receive them. While the

Internal Revenue Code and the Regulations thereunder provide rules permitting the use of successor beneficiary life expectancies, the Qualified Plan or IRA Custodial agreement may not. Since the Qualified Plan or IRA Custodial agreement controls, the longer life expectancies permitted by the tax rules may not be available. Consequently, an upside to a Spousal Rollover is the ability to add certainty to the life expectancy that can be used upon the death of the surviving spouse.

For the foregoing reasons, there is a tension between the surviving spouse rolling and not rolling over an Inherited Qualified Plan/IRA. Relief lies in the fact that a surviving spouse can effect a Spousal Rollover any time after the death of the original owner. If the surviving spouse is under age 59½ and the goal is to give the survivor penalty-free access to the funds while ensuring the maximum stretch, he or she should maintain the account as an Inherited Qualified Plan/IRA until age 59½. After reaching age 59½ the surviving spouse can roll over the account in order to avail himself or herself of the incidents of ownership.

### **Multiple Designated Beneficiaries**

It often suits the account owner's purpose to name multiple Designated Beneficiaries. For example, the beneficiary designation form may read something to the effect of "equally to my brother and three nephews." For purposes of "stretch" planning, however, naming multiple beneficiaries can produce unintended and unfortunate results. The reason for this is that the law looks at the population of all Designated Beneficiaries, selects the one with the shortest life expectancy, and imputes that life expectancy to all the others. In other words, a single life expectancy is used for all beneficiaries, irrespective of their actual ages. If there is a large disparity in the ages of the beneficiaries, this outcome is disastrous as the younger beneficiaries are stuck taking their RMDs over the life expectancy of the oldest.

All is not lost, however. Under appropriate circumstances, the law allows an Inherited IRA to be divided into separate accounts, one for each of the Designated Beneficiaries. As long as the division occurs by December 31 the year following the original owner's death, each beneficiary can use his or her own life expectancy in determining RMDs. Disaster is avoided.

### **USE OF DISCLAIMERS**

No discussion about stretching IRAs is complete without mentioning Qualified Disclaimers. A Qualified Disclaimer is a legal "no thank you." In other words, a Designated Beneficiary legally declines to accept what he or she is otherwise entitled to. A Designated Beneficiary who disclaims an interest is treated as if he or she predeceased the original owner. In this event, his or her interest passes to the next Designated Beneficiary in line. By coupling Qualified Disclaimers with skillful naming of contingent Designated Beneficiaries, significant flexibility is added to the planning.

### Qualified Plan/IRA Distribution Guidelines

<b>Traditional IRAs, including SEPs and Simple IRAs</b>	Distributions must begin by April 1 of the year after the owner turns 70½
<b>Qualified Plan participant (including 403(b) plans) owning more than 5% of the plan sponsor</b>	Distributions must begin by April 1 following the later of: 1) the year the participant turns 70½; or 2) the participant's retirement from the company
<b>Qualified Plan participant who owns 5% or less of the plan sponsor</b>	Distributions must begin by April 1 of the year following the year the participant turns 70½
<b>Qualified Plan participant with a TEFRA 242(b) election in effect</b>	Date of retirement
<b>Roth IRAs</b>	No RBD as to the original owner

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## Effect of Beneficiary Designations: Participant Dies Before Required Beginning Date

DESIGNATED BENEFICIARY	OPTIONS
<b>Spouse</b>	<ol style="list-style-type: none"> <li>1. RMDs postponed until later of: Year following participant's death; Year participant would have attained 70½; or End of the 5th year after the participant's death, if the plan permits and the surviving spouse elects.</li> <li>2. RMDs over spouse's life expectancy (unless 5-year rule is used).</li> <li>3. Rollover available.</li> </ol>
<b>Nonspouse</b>	<ol style="list-style-type: none"> <li>1. RMDs over single life of designated beneficiary beginning in year following death. This factor is reduced by one for each year thereafter. Otherwise, distributions must be completed by end of 5th year following participant's death.</li> <li>2. Rollover available if made as a direct transfer to an inherited IRA.</li> </ol>
<b>Trust</b>	<ol style="list-style-type: none"> <li>1. RMDs over life of oldest trust beneficiary beginning in the year following death if trust qualifies as designated beneficiary.</li> <li>2. If trust does not qualify as designated beneficiary, RMDs must be completed by the end of the 5th year following participant's death.</li> <li>3. Rollover available for a qualified trust if made as a direct transfer to an inherited IRA on behalf of the trust, with the trust identified as the beneficiary.</li> <li>4. Eligible for spousal rollover if the trust is a qualified trust and all distributions from the plan are payable to the spouse during his or her life.</li> </ol>
<b>No Beneficiary (Estate or Charity)</b>	<ol style="list-style-type: none"> <li>1. Distributions must be completed by end of 5th year following participant's death.</li> <li>2. Spousal rollover may be available if the surviving spouse has the right to receive all plan assets and can cause plan benefits to be distributed to himself or herself.</li> </ol>

### Effect of Beneficiary Designations: Participant Dies After Required Beginning Date

DESIGNATED BENEFICIARY	OPTIONS
Spouse	<ol style="list-style-type: none"> <li>1. Distributions can be made over the spouse's single life expectancy recalculated annually. At spouse's death, RMDs are made over spouse's remaining single life determined in year of death and reduced by one for each year thereafter.</li> </ol>
Nonspouse	<ol style="list-style-type: none"> <li>2. Rollover available.</li> <li>1. RMDs over the beneficiary's single life expectancy.</li> <li>2. Rollover available if made as a direct transfer to an inherited IRA.</li> </ol>
Trust	<ol style="list-style-type: none"> <li>1. If trust qualifies as designated beneficiary, RMDs over the life expectancy of the oldest beneficiary.</li> <li>2. If trust does not qualify as designated beneficiary, RMDs over the owner's life expectancy.</li> <li>3. Rollover available for a qualified trust if made as a direct transfer to an inherited IRA on behalf of the trust, with the trust identified as the beneficiary.</li> <li>4. Should be eligible for spousal rollover if the trust is a qualified trust and all distributions from the plan are payable to the spouse during his or her life.</li> </ol>
No Beneficiary (Estate or Charity)	<ol style="list-style-type: none"> <li>1. RMDs over the owner's life expectancy.</li> <li>2. Spousal rollover may be available if the surviving spouse has the right to receive all plan assets and can cause plan benefits to be distributed to him or herself.</li> </ol>