Chapter 7: Retirement

Corrections were made to this workbook through January of 2003. No subsequent modifications were made.

INTRODUCTION

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) is one of the most significant tax law changes in many years. A major part of this law impacts retirement savings. Congress provided new opportunities for taxpayers to contribute higher amounts of dollars for planned retirement needs. For the most part, changes are effective beginning 2002. However, over the next eight years, scheduled increases are planned for certain retirement plans.

The IRS simplified the "Required Minimum Distribution Rules." Prior to 2001, these rules were a major problem for both taxpayers and tax and financial planning practitioners.

This chapter will focus on these two areas of the law. The chapter will **not** discuss which type of retirement plan best suits a particular taxpayer. However, a retirement plan comparison chart is provided in Appendix B.

Note. The higher retirement plan contribution limits for 2002 are proving to be a problem for some states. Sixteen states and Washington D.C. must amend their laws to allow extra contributions. These states are: Arizona, Arkansas, California, Georgia, Hawaii, Idaho, Indiana, Iowa, Kentucky, Maine, Massachusetts, New Jersey, North Carolina, South Carolina, West Virginia, and Wisconsin. If state laws are not revised, plan contributors would owe state income tax to the extent contributions exceed 2001 limits. Many states are reluctant to conform to the federal tax law since they are experiencing budget shortfalls due to the economic slowdown. Practitioners should check with their particular state to see if law changes have been made.

IMPACT OF 2001 ACT ON RETIREMENT

EMPLOYER-PROVIDED RETIREMENT ADVICE

Act §665
[I.R.C. §§132(a)(7) and (m)]
Effective Date: Years beginning after December 31, 2001.

Qualified retirement planning services provided by an employer are excluded from income.

Background. There was no specific exclusion under the old law for employer-provided retirement planning services. However, such services could be excludable as employer-provided educational assistance or fringe benefit.

New Law. Beginning in 2002, qualified retirement planning services, provided to an employee and his/her spouse by an employer maintaining a qualified plan, are excludable from income and wages. The exclusion does not apply for highly compensated employees, unless the services are available on substantially the same terms to each member of the group of employees normally provided education and information regarding the employer's qualified plan. "Qualified retirement planning services" include retirement planning advice and information. The exclusion is not limited to information regarding the qualified plan. For example, the exclusion applies to advice and information regarding retirement income planning for an individual and his/her spouse and how the employer's plan fits into the individual's overall retirement planning, such as tax preparation, accounting, legal, or brokerage services.

This provision clarifies the treatment of retirement advice provided in a nondiscriminatory manner. It is intended that the Secretary of the Treasury, in determining the application of the exclusion to highly compensated employees, may permit employers to take into consideration employee circumstances other than compensation and position in providing advice to classifications of employees. Thus, for example, the Secretary may permit employers to limit certain advice to individuals nearing retirement age under the plan.

INCREASE IN PENSION AND IRA CONTRIBUTION LIMITS

Act §§601, 611, 616, and 631
[I.R.C. §§219, 404, 408, 415]
Effective Date: Tax years beginning after December 31, 2001.

Limits on contributions to pension plans and IRAs are increased.

The limits on contributions to pension and individual retirement plans are increased as shown on the following table.

Year	IRAs	SIMPLE	457	401 (k) 403 (b) SARSEP	Defined Contribution Plan	Defined Benefit Plan	Compensation Limit	Stock Bonus SEP and Profit Sharing
2001	$2,000	$6,500	$8,500	$10,500	$35,000	$140,000	$170,000	15%
2002	$3,000	$7,000	$11,000	$11,000	$40,000	$160,000	$200,000	25%
2003	$3,000	$8,000	$12,000	$12,000	(II)	(III)	(III)	25%
2004	$3,000	$9,000	$13,000	$13,000	(II)	(III)	(III)	25%
2005	$4,000	$10,000	$14,000	$14,000	(II)	(III)	(III)	25%
2006	$4,000	(I)	$15,000	$15,000	(II)	(III)	(III)	25%
2007	$4,000	(I)	(I)	(I)	(II)	(III)	(III)	25%
2008	$5,000	(I)	(I)	(I)	(II)	(III)	(III)	25%
2009-2010	(I)	(I)	(I)	(I)	(II)	(III)	(III)	25%
2011 and after	(IV)	(IV)	(IV)	(IV)	(IV)	(IV)	(IV)	15%

(I) The limit is adjusted annually for inflation in $500 increments.
(II) The limit is adjusted annually for inflation in $1,000 increments.
(III) The limit is adjusted annually for inflation in $5,000 increments.
(IV) The 2001 Act provisions are repealed, which means rates return to the inflation-adjusted 2001 limits.

In addition, the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147) contains a number of provisions affecting retirement plan tax rules. These provisions are primarily technical corrections, additions, or clarifications of provisions in the 2001 Act.

Simplified Employee Pensions (SEP's)

The 2002 tax bill increases the percentage of compensation limit on SEP annual contributions to 25%. This change makes the percentage of compensation limit for contributions the same as for deductions.

> **Note.** Increasing the contribution limit to 25% means an employer can make an SEP contribution on behalf of an employee that, before the 2001 Act, would have required **both** a profit sharing and a money purchase pension plan to be in place.

> **Caution.** There are drawbacks involved with sponsoring an SEP rather than a traditional tax-qualified plan that may still make the SEP not the best choice. For example, if an employer wanted to offer employees the ability to choose salary deferrals (instead of the employer funding 100% of the retirement plan contributions), the traditional 401(k), or grandfathered SARSEP might be the best choice.

ELECTIVE DEFERRALS NOT TAKEN INTO ACCOUNT FOR PURPOSES OF DEDUCTION LIMITS

Act §614
[I.R.C. §404(n)]
Effective Date. The provision is effective for years beginning after December 31, 2001.

> Elective deferral contributions are not subject to the deduction limits and are not taken into account for any other employer contribution limits.

Background. Under the old law, employer contributions to one or more qualified retirement plans were deductible subject to certain limits. In general, the deduction limit depended on the kind of plan.

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In the case of a defined benefit pension plan or a money purchase pension plan, the employer generally could deduct the amount necessary to satisfy the minimum funding cost of the plan for the year. If a defined benefit pension plan had more than 100 participants, the maximum amount deductible was at least equal to the plan's unfunded current liabilities.

In the case of a profit-sharing or stock bonus plan, the employer generally could deduct an amount equal to 15% of compensation of the employees covered by the plan for the year.

If an employer sponsored both a defined benefit pension plan and a defined contribution plan that covered some of the same employees (or a money purchase pension plan and another kind of defined contribution plan), the total deduction for all plans for a plan year generally was limited to the greater of:

- 25% of compensation, or
- the contribution necessary to meet the minimum funding requirements of the defined benefit pension plan for the year, or the amount of the plan's unfunded current liabilities, in the case of a plan with more than 100 participants.

For purposes of the deduction limits, employee elective deferral contributions to an I.R.C. §401(k) plan were treated as employer contributions and, thus, were subject to the generally applicable deduction limits.

New Law. The 2002 tax bill removes this combined limit restriction when the defined contribution plan only receives employee elective deferrals.

> **Note.** For employers who have both a defined contribution and defined benefit plan in place, and who are interested in maximizing contributions to the defined benefit plan, this change is extremely important.

Under the 2001 Act, elective deferral contributions are not subject to the deduction limits. The application of a deduction limitation to any other employer contribution to a qualified retirement plan does not take into account elective deferral contributions.

Example 1. In **2001**, Kimberly elected to put $10,000 of her salary into her employer's 401(k) plan. That $10,000 contribution **reduces** the limit on her employer's contribution to her 401(k) by $10,000.

If Kimberly elects to put $10,000 of salary into her employer's 401(k) plan in **2002**, it will **not reduce** the limit on her employer's contribution.

Employee Elective Deferrals to a SEP

The 2002 tax bill made two important changes with respect to the treatment of elective deferrals under a SEP. These changes will enable employees to make larger deductible contributions to the plan.

1. "Compensation" includes salary reduction contributions for purposes of determining limits on deductions for SEP contributions; and
2. "Elective deferrals" are no longer counted as employer contributions for purposes of applying SEP deduction limits.

In the case of SARSEP (salary reduction-SEP), these changes will permit larger deductible contributions by the employer when the employee makes elective deferral contributions to a grandfathered SARSEP. Although new SEP's cannot have a salary reduction feature, there are a large number of grandfathered SARSEP's.

Effect on sole-proprietor 401(k)s. The sole proprietor can elect the maximum $11,000 deferral as an employee. That deferral does not reduce the limit that the sole proprietor can contribute as an employer. The employer's limit is 20% of up to $200,000 of compensation. This change makes a 401(k) attractive for a sole proprietor who wants to put a large portion of his/her business income into retirement savings. Under old law, a sole proprietor could contribute almost the same amount to a SIMPLE or SEP and avoid the extra cost of setting up a 401(k). Beginning in 2002, the extra cost of a 401(k) may be worthwhile because the total amount that can be contributed is increased substantially.

Example 2. Sharon owns a business as a sole proprietor and has $100,000 of profits each year. If she had a 401(k) plan in **2001**, she could elect to defer $10,500 of her before-tax income into a 401(k) plan. In addition, her business could contribute the remainder of the contribution limit. That limit is 13.0435% of her $100,000 compensation, reduced by her $10,500 elective deferral and half of her $12,648 of self-employment tax.

Her contribution limit was:

Compensation	$100,000
Less elective deferral	(10,500)
Less 1/2 of $12,648	(6,324)
Balance	$83,176
Percentage	× .130435
Limit	$10,849

Therefore, Sharon's business could contribute $349 ($10.849 - $10,500) in 2001.

In **2002**, Sharon can elect to defer $11,000 of her before-tax income into a 401(k). That reduces her compensation for the contribution limit, but it does not reduce the limit. Assuming the same self-employment tax for 2002 as for 2001, the total contribution limit for 2002 is:

Elective deferral		$11,000
Compensation	$100,000	
Less elective deferral	(11,000)	
Less 1/2 of $12,648	(6,324)	
Balance	$82,676	
Percentage	× .20	
Employer limit		$16,535
Total contribution limit		$27,535

EMPLOYEE CONTRIBUTIONS TO DEFINED CONTRIBUTION PLANS LIMITED TO 100% OF COMPENSATION

Act §632
[I.R.C. §415(c)(1)]
Effective Date: Years beginning after December 31, 2001, except as noted.

- Contribution limit for defined contribution plans are increased to 100% of compensation.
- Contribution limit for I.R.C. §457 plans is increased to 50% of compensation for 2002-2009 and to 100% for 2010.

- The provision regarding the regulations under I.R.C. §403(b)(2) is effective on the date of enactment.
- The provision regarding the repeal of the exclusion allowance applicable to tax-sheltered annuities is effective for years beginning after December 31, 2010.

Old Law. The old law imposed limits on the contributions that could be made to tax-favored retirement plans.

Defined contribution plans. In the case of a tax-qualified defined contribution plan, the limit on annual additions that could be made to the plan on behalf of an employee was the lesser of $35,000 (for 2001) or 25% of the employee's compensation [I.R.C. §415(c)]. Annual additions included employer contributions, including contributions made at the election of the employee (i.e., employee elective deferrals), after-tax employee contributions, and any forfeitures allocated to the employee. For this purpose, compensation meant taxable compensation of the employee, plus elective deferrals, and similar salary reduction contributions. A separate limit applied to benefits under a defined benefit plan.

For years before January 1, 2000, an overall limit applied if an employee was a participant in both a defined contribution plan and a defined benefit plan of the same employer.

Tax-sheltered annuities. In the case of a tax-sheltered annuity (an "I.R.C. §403(b) annuity"), the annual contribution generally could not exceed the lesser of the exclusion allowance or the I.R.C. §415(c) defined contribution limit. The exclusion allowance for a year was equal to 20% of the employee's includible compensation, multiplied by the employee's years of service, minus excludable contributions for prior years under qualified plans, tax-sheltered annuities or I.R.C. §457 plans of the employer.

In addition to this general rule, employees of nonprofit educational institutions, hospitals, home health service agencies, health and welfare service agencies, and churches could elect application of one of several special rules that increase the amount of the otherwise permitted contributions. The election of a special rule was irrevocable; an employee could not elect to have more than one special rule apply.

Under one special rule, in the year the employee separates from service, the employee could elect to contribute up to the exclusion allowance, without regard to the 25% of compensation limit under I.R.C. §415. Under this rule, the exclusion allowance was determined by taking into account no more than 10 years of service.

Under a second special rule, the employee could contribute up to the lesser of:

- The exclusion,
- The allowance,
- 25% of the participant's includible compensation, or
- $15,000.

Under a third special rule, the employee could elect to contribute up to the I.R.C. §415(c) limit, without regard to the exclusion allowance. If this option was elected, then contributions to other plans of the employer were also taken into account in applying the limit.

For purposes of determining the contribution limits applicable to I.R.C. §403(b) annuities, includable compensation meant the amount of compensation received from the employer for the most recent period which could be counted as

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a year of service under the exclusion allowance. In addition, includable compensation included elective deferrals and similar salary reduction amounts.

Treasury regulations included provisions regarding application of the exclusion allowance in cases where the employee participated in an I.R.C. §403(b) annuity and a defined benefit plan. The Taxpayer Relief Act of 1997 directed the Secretary of the Treasury to revise these regulations, effective for years beginning after December 31, 1999, to reflect the repeal of the overall limit on contributions and benefits.

I.R.C. §457 plans. Compensation deferred under an eligible deferred compensation plan of a tax exempt or state and local governmental employer (an "I.R.C. §457 plan") was not includible in gross income until paid or made available. In general, the maximum permitted annual deferral under such a plan was the lesser of (1) $8,500 (in 2001), or (2) 33$^{1}/_{3}$% of compensation. The $8,500 limit was indexed for inflation.

New Law. The 2001 Act increases the limits for contributions to defined contribution plans and I.R.C. §457 plans.

Increase in defined contribution plan limit. The 2001 Act increases the 25% of compensation limitation on annual additions under a defined contribution plan to 100%.

I.R.C. §457 plans. The provision increases the 33$^{1}/_{3}$% of compensation limitation on deferrals under an I.R.C. §457 plan to 50% for 2002 through 2010, and 100% for 2011 and thereafter.

> **Example 3.** Kevin's salary is $100,000. In **2001**, the limit on his contribution to his employer's defined contribution plan is the lesser of $35,000 or 25% of his $100,000 salary, which is $25,000.
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> In **2002**, if Kevin's salary remains at $100,000, the limit on his contribution is the lesser of $40,000 or his $100,000 salary.

ADDITIONAL CATCH-UP CONTRIBUTIONS

Act §601
[I.R.C. §219(b)(2)(B)]
Effective Date: Tax years beginning after December 31, 2001.

Individuals, age 50 and older, can make catch-up contributions to retirement plans.

The 2001 Act allows individuals who have attained age 50 to make additional catch-up contributions to retirement plans. These contributions are in addition to the regularly applicable dollar limits, but total contributions cannot exceed earnings. The increase in the IRA limit is also subject to the AGI phase-out limits. The catch-up contribution provision does not apply to after-tax employee contributions. In the case of an I.R.C. §457 plan, this catch-up rule does not apply during the participant's last three years before retirement. In those years, the regularly applicable dollar limit is doubled.

Catch-Up Contribution Limits

Year	IRA	SIMPLE	401(k); 403(b); 457; and SEP
2002	$500	$500	$1,000
2003	$500	$1,000	$2,000
2004	$500	$1,500	$3,000
2005	$500	$2,000	$4,000
2006 and after	$1,000	$2,500	$5,000

The Job Creation and Worker Assistance Act of 2002 (P.L. 107-147) clarified the following points not completely explained in the 2001 tax act.

Catch-up contributions:

1. May be made to retirement plans from the **beginning of the year** a participant turns age 50,
2. **Are not included in gross income**, and
3. **Do not impact the plan nondiscrimination rules**.

The following examples illustrate the application of the new provision for the tax year 2002.

Example 4. Jane is a highly compensated employee, over age 50 and who participates in a 401(k) plan sponsored by her employer. The maximum annual deferral limit (without regard to the provision) is $11,000. After application of the special nondiscrimination rules applicable to 401(k) plans, the maximum elective deferral Jane may make for the year is $8,000. Under the provision, Jane is able to make additional catch-up salary reduction contributions of $1,000 for a total contribution of $9,000.

Example 5. Ben, who is over age 50, is a participant in a 401(k) plan. Ben's compensation for the year is $30,000. The maximum annual deferral limit (without regard to the provision) is $11,000. Under the terms of the plan, the maximum permitted deferral is 10% of compensation or, in Ben's case, $3,000. Under the provision, Ben can contribute up to $4,000 for the year ($3,000 under the normal operation of the plan, and an additional $1,000 under the provision).

FASTER VESTING FOR MATCHING CONTRIBUTIONS

Act §632
[I.R.C. §411]
Effective Date: Contributions for plan years beginning after December 31, 2001 except as noted below.

More rapid vesting schedules apply to employer matching contributions.

Background. Under the old law, a plan was not a qualified plan unless a participant's employer-provided benefit vested at least as rapidly as one of two alternative minimum vesting schedules.

1. A plan satisfied the **first** schedule if a participant acquired a non-forfeitable right to 100% of the participant's accrued benefit derived from employer contributions upon the completion of five years of service.
2. A plan satisfies the **second** schedule if a participant has a non-forfeitable right to at least 20% of the participant's accrued benefit derived from employer contributions after three years of service, 40% after four years of service, 60% after five years of service, 80% after six years of service, and 100% after seven years of service.

New Law. Beginning in 2002, more rapid vesting schedules apply to employer matching contributions. Under the provision, employer matching contributions are required to vest at least as rapidly as under one of the following two alternative minimum vesting schedules.

1. A plan satisfies the **first** schedule if a participant acquires a non-forfeitable right to 100% of employer matching contributions upon the completion of three years of service.
2. A plan satisfies the **second** schedule if a participant has a non-forfeitable right to 20% of employer matching contributions for each year of service beginning after the participant's second year of service and ending with 100% after 6 years of service.

Effective Date. The provision is effective for contributions to plans beginning after December 31, 2001, with a delayed effective date for plans maintained under a collective bargaining agreement. The provision does not apply to any employee until the employee has an hour of service after the effective date. In applying the new vesting schedule, service before the effective date is taken into account.

ROLLOVERS AMONG VARIOUS TYPES OF PLANS

Act §§641, 642, and 643
[I.R.C. §§402, 403(b), 408, and 457]
Effective Date: Distributions made after December 31, 2001, except as noted.

Rollovers are allowed among various retirement plans.

In General. The 2001 Act provides that eligible rollover distributions from qualified retirement plans, I.R.C. §403(b) annuities, and governmental I.R.C. §457 plans generally could be rolled over to any of these plans or arrangements. Similarly, distributions from an IRA generally are permitted to be rolled over into a qualified plan, I.R.C. §403(b) annuity, or governmental I.R.C. §457 plan. The direct rollover and withholding rules are extended to distributions from a governmental I.R.C. §457 plan. These plans are required to provide written notification regarding eligible rollover distributions. The rollover notice (for all plans) is required to include a description of the provisions under which distributions from the plan to which the distribution is rolled over may be subject to restrictions and tax consequences different than those applicable to distributions from the distributing plan. Qualified plans, I.R.C. §403(b) annuities, and I.R.C. §457 plans would not be required to accept rollovers.

The elective withholding rules applicable to distributions from qualified plans and I.R.C. §403(b) annuities that are not eligible rollover distributions are also extended to distributions from governmental I.R.C. §457 plans. Thus, periodic distributions from governmental I.R.C. §457 plans, that are not eligible rollover distributions, are subject to withholding as if the distributions were wages. Non-periodic distributions from such plans, that are not eligible rollover distributions, are subject to withholding at a 10% rate. In either case, the individual may elect not to have withholding apply.

Some special rules apply in certain cases. A distribution from a qualified plan is not eligible for capital gains or averaging treatment if there was a rollover to the plan that would not have been permitted under present law. Therefore, in order to preserve capital gains and averaging treatment for a rolled over qualified plan distribution, the rollover would have to be made to a "conduit IRA" as under present law, and then rolled back into a qualified plan. Amounts distributed from an I.R.C. §457 plan are subject to the early withdrawal tax to the extent the distribution consists of amounts attributable to rollovers from another type of plan. I.R.C. §457 plans are required to separately account for such amounts.

Rollover of After-Tax Contributions. The provision provides that employee after-tax contributions may be rolled over into another qualified plan or a traditional IRA. In the case of a rollover from a qualified plan to another qualified plan, the rollover is permitted to be accomplished only through a direct rollover. In addition, a qualified plan would not be permitted to accept rollovers of after-tax contributions unless the plan provides separate accounting for such contributions (and earnings thereon). After-tax contributions, including nondeductible contributions to an IRA, would not be permitted to be rolled over from an IRA into a qualified plan, tax-sheltered annuity, or I.R.C. §457 plan.

In the case of a distribution from a traditional IRA that is rolled over into an eligible rollover plan that is not an IRA, the distribution is attributed first to amounts other than after-tax contributions.

Expansion of Spousal Rollovers. The provision provides that surviving spouses may roll over distributions to a qualified plan, I.R.C. §403(b) annuity, or governmental I.R.C. §457 plan in which the surviving spouse participates.

Treasury Regulations. The Secretary of the Treasury is directed to prescribe rules necessary to carry out the provision. Such rules may include reporting requirements and mechanisms to address mistakes relating to rollovers. It is anticipated that the IRS would develop forms to assist individuals who roll over after-tax contributions to an IRA in keeping track of such contributions. Such forms could expand Form 8606-Nondeductible IRAs, to include information regarding after-tax contributions.

Effective Date. The provision is effective for distributions made after December 31, 2001. It is intended that the Secretary will revise the safe harbor rollover notice which plans may use to satisfy the rollover requirements. No penalty is imposed on a plan for a failure to provide the information required under the provision for any distribution made before the date that is 90 days after the date the Secretary issues a new safe-harbor rollover notice, if the plan administrator makes a reasonable attempt to comply with such notice requirement. For example, the provision requires the rollover notice include a description of the provisions under which distributions from the eligible retirement plan receiving the distribution may be subject to restrictions and tax consequences which are different from those applicable to distributions from the plan making the distribution. A plan is treated as making a reasonable good faith effort to comply with this requirement if the notice states that distributions from the plan to which the rollover is made may be subject to different restrictions and tax consequences than those that apply to distributions from the plan from which the rollover is made.

PLAN LOANS FOR S CORPORATION OWNERS, PARTNERS, MEMBERS OF LLCS, AND SOLE PROPRIETORS

Act §612
[I.R.C. §4975(f)(6)]
Effective Date: Years beginning after December 31, 2001.

Owner-employees are allowed to receive loans from retirement plans.

Background. The Internal Revenue Code prohibits certain transactions ("prohibited transactions") between a qualified plan and a disqualified person. This is intended to prevent persons with a close relationship to the qualified plan from using that relationship to the detriment of plan participants and beneficiaries. Certain types of transactions are exempted from the prohibited transaction rules, including loans from the plan to plan participants, if certain requirements are satisfied.

The statutory exemptions to the prohibited transaction rules do not apply to certain transactions in which the plan makes a loan to an owner-employee. Loans to participants other than owner-employees are permitted if loans:

- Are available to all participants on a reasonably equivalent basis;
- Are not made available to highly compensated employees in an amount greater than made available to other employees;
- Are made in accordance with specific provisions in the plan;
- Bear a reasonable rate of interest; or
- Are adequately secured.

In addition, the Code places limits on the amount of loans and repayment terms.

For purposes of the prohibited transaction rules, an owner-employee means:

- A sole proprietor,
- A partner who owns more than 10% of either the capital interest or the profits interest in the partnership,
- An employee or officer of a subchapter S corporation who owns more than 5% of the outstanding stock of the corporation, and
- The owner of an individual retirement arrangement (IRA).

The term owner-employee also includes certain family members of an owner-employee and certain corporations owned by an owner-employee.

Under the Code, a two-tier excise tax is imposed on disqualified persons who engage in a prohibited transaction. The first level tax is equal to 15% of the amount involved in the transaction. The second level tax is imposed if the prohibited transaction is not corrected by the earlier of:

- The date of mailing a notice of deficiency with respect to the first level tax, or

- The date of which the first level tax is assessed.

The second level tax is equal to 100% of the amount involved.

New Law. The 2001 Act generally **eliminates** the special present-law rules relating to plan loans made to an owner-employee (other than the owner of an IRA). Thus, the general statutory exemption applies to such transactions. Prior law continues to apply with respect to IRAs.

> **Example 6.** Linda owns a sole proprietorship that has 10 employees. The business set up a retirement plan for Linda and all of the employees. In **2001**, a loan to any of the employees is not a prohibited transaction under I.R.C. §4975, but a loan to Linda is a prohibited transaction. Beginning in **2002**, a loan to Linda is not a prohibited transaction.

CREDIT FOR PENSION PLAN STARTUP COSTS FOR SMALL EMPLOYERS

Act §619
[New I.R.C. §45E]
Effective Date: Costs paid or incurred in taxable years beginning after December 31, 2001, with respect to plans established after such date.

> A nonrefundable tax credit is allowed for administrative and retirement education expenses incurred by a small business that adopts a qualified retirement plan. The credit is equal to 50% of the first $1,000 of qualified expenses.

The 2001 Act provides a nonrefundable income tax credit for 50% of the administrative and retirement-education expenses for any small business that adopts a new qualified defined benefit or defined contribution plan (including a 401(k) plan), SIMPLE plan, or simplified employee pension (SEP). The credit applies to 50% of the first $1,000 in administrative and retirement-education expenses for the plan for each of the first three years of the plan.

The credit is available to an employer that did not employ, in the preceding year, more than 100 employees with compensation in excess of $5,000. In order for an employer to be eligible for the credit, the plan must cover at least one employee who is not highly compensated. In addition, if the credit is for the cost of a payroll deduction IRA arrangement, the arrangement must be made available to all employees who worked for at least three months.

The credit is a general business credit. The 50% of qualifying expenses that are effectively offset by the tax credit are not deductible; the remaining 50% of the qualifying expenses (and other expenses) are deductible to the extent permitted under present law.

> **Example 7.** In 2002, ACE Buildings, LLC paid an accountant $800 to set up a SIMPLE IRA for its employees. ACE can claim a $400 ($800 ÷ 50%) credit in 2002 and can deduct the remaining $400.

CREDIT FOR ELECTIVE DEFERRALS AND IRA CONTRIBUTIONS

Act §618
[New I.R.C. §25B]
Effective Date: Tax years beginning after December 31, 2001 and before January 1, 2007.

> A nonrefundable credit is allowed for contributions to a qualified retirement plan. The maximum credit is 50% of up to $2,000 of contributions. The credit is reduced to zero as AGI increases.

The 2001 Act provides a temporary nonrefundable tax credit for contributions made by eligible taxpayers to a qualified plan. The maximum annual contribution eligible for the credit is $2,000. The credit rate depends on the adjusted gross income (AGI) of the taxpayer, determined without regard to the:

- Foreign income exclusion and foreign housing exclusion or deduction (I.R.C. §911)
- Exclusion of income from American Samoa, Guam, or the Northern Mariana Islands (I.R.C. §931)
- Exclusion of income from Puerto Rico (I.R.C. §933)

Only joint returns with AGI of $50,000 or less, head of household returns of $37,500 or less, and single returns of $25,000 or less are eligible for the credit. The AGI limits applicable to single taxpayers apply to married taxpayers filing separate returns.

The credit is in addition to any deduction or exclusion that would otherwise apply for the contribution. The credit offsets alternative minimum tax liability, as well as regular tax liability. The credit is available to individuals who are 18 or over, other than individuals who are full-time students or claimed as a dependent on another taxpayer's return.

The credit is available for elective contributions to a:

- 401(k) plan,
- 403(b) annuity,
- 457 plan,
- SIMPLE,
- SEP,
- Traditional or Roth IRA, or
- Voluntary after-tax employee contribution to a qualified retirement plan.

The present-law rules governing these contributions continue to apply.

The amount of any contribution eligible for the credit is reduced by taxable distributions received by the taxpayer and his/her spouse from any savings arrangement described above. It is also reduced by any other qualified retirement plan:

- During the taxable year for which the credit is claimed;
- During the two taxable years prior to the year the credit is claimed; or
- During the period after the end of the taxable year and prior to the due date for filing the taxpayer's return for the year.

In the case of a distribution from a Roth IRA, this rule applies to any such distributions, whether taxable or not.

The credit rates based on AGI are as follows:

Credit Rates Based on AGI

Married Filing Jointly		Head of Household		All Others		Applicable Percentage
Over	Not Over	Over	Not Over	Over	Not Over	
$0	$30,000	$0	$22,500	$0	$15,000	50
30,000	32,500	22,500	24,375	15,000	16,250	20
32,500	50,000	24,375	37,500	16,250	25,000	10
50,000		37,500		25,000		0

Example 8. Robert is not married and is not a head of household. In **2002** he has $20,000 of AGI and contributes $500 to his IRA. He is allowed a $50 ($500 ÷ 10%) credit under I.R.C. §25B.

OVERVIEW OF NEW AND "FINAL" MINIMUM DISTRIBUTION RULES

In January, 2001, the IRS issued proposed regulations, which replaced the overly complex "previous" proposed regulations of 1987. These "previous" proposed regulations left both retirement plan owner and planners alike amazed at the knowledge level needed to make the proper elections, and compute distributions, affecting retirement plan payouts.

The January, 2001, "revised" proposed regulations significantly reduced the complexity of the retirement plan payout rules and provided a new "Uniform Table" which increased the payout period, thereby reducing annual minimum payouts. These "revised" proposed regulations were effective starting January 1, 2002, but could be used starting January 1, 2001.

In **April 2002**, the IRS issued **"final" regulations**, which completely restate and replace both versions of the proposed regulations (1987 and 2001). However, **all 3 sets of regulations apply in varying degrees in 2002**.

The **"final" regulations** absolutely apply for calendar years **beginning on or after January 1, 2003**. All plan payouts, starting January 1, 2003, must conform to the final regulations (April 2002), even if the original payout schedule was determined under the 1987 or 2001 "proposed" regulations.

Note. Required minimum distributions for the calendar year **2001** could be computed using either the 1987 or 2001 "proposed" regulations. Those plan owners who desired to reduce their required minimum distributions would have followed the 2001 rules if their retirement plan trustee allowed the change.

Note. Required minimum distribution calculations and distributions for calendar years 1987-2001 that were in compliance with the proposed regulations (1987 & 2001) in effect "at the time", have been **safe harbored** by the IRS. (Preamble to Regs 1.401(a)(9)0-9 5/13/02)

Note. For purposes of this chapter, all references to the "final" regulations means the April 2002 final regulations.

UNIFORM LIFETIME TABLE (NEW TABLE III)

The 2002 final regulations maintain simplifications made to the minimum distribution rules for separate accounts provided in the 2001 proposed regulations. This includes the calculation of the required minimum distribution during the individual's lifetime using Table III — Uniform Lifetime Distribution. The basic calculation for the required minimum distribution for individual accounts is determined by dividing the account balance by the distribution period. For lifetime required minimum distributions, there is a uniform distribution period for almost all plan owners of the same age. This "new" **Uniform Lifetime Distribution Period Table** is based on the joint life and last survivor expectancy of **an individual and a hypothetical beneficiary 10 years younger**. However, if the plan owner's sole beneficiary is his/her spouse and **the spouse is more than 10 years younger**, a longer distribution period measured by the **Joint Life and Last Survivor Life Expectancy** of the plan owner and spouse is permitted to be used. (New Table II)

After the year of the plan owner's death, the distribution period is generally the remaining life expectancy of the designated beneficiary (New Table I). The beneficiary's remaining life expectancy is calculated using the age of the beneficiary in the year following the year of the plan owner's death, reduced by one for each subsequent year. This method of calculation is known as "term certain." If the plan owner's spouse is the sole beneficiary, the distribution period during the spouse's life is the spouse's single life expectancy (New Table I). After the year of the spouse's death, the distribution period is the spouse's life expectancy calculated in the year of death, reduced by one for each subsequent year. If there is no designated beneficiary, the distribution period is the plan owner's life expectancy calculated in the year of death, reduced by one for each subsequent year.

The "Uniform Lifetime Table" is included in a supplement to IRS Pub. 590 (June 2002). This table is referred to as "Table III," and is included in Appendix A at the end of this chapter.

NEW MORTALITY TABLES (NEW TABLES I & II)

The Single Life Table and the Joint and Last Survivor Table were also modified in the April 2002 final regulations. These modifications generally reflected longer life expectancies, and were based on the 2000 Individual Annuity Mortality Table with projected mortality improvement for the period 2000 through 2003.

These new mortality tables are included in the Supplement to IRS Pub. 590 (June 2002). These tables are referred to as Table I (Single Life Expectancy), and Table II (Joint Life and Last Survivor Expectancy), and are included in Appendix A at the end of this chapter.

The Single Life Table (Table I) is used to determine the life expectancy factor of the beneficiary of the deceased plan owner. The Joint and Last Survivor Expectancy Table (Table II) is used by the plan owner in the situation where the sole beneficiary is the spouse, and the spouse is more than 10 years younger. The Single Life Table (Table I) is only used by the beneficiary of a deceased plan owner. The Joint and Last Survivor Expectancy Table is used (electively) instead of the Uniform Lifetime Table, and can only be used when a spouse is more than 10 years younger. Use of the Joint and Last Survivor Expectancy Table will generally result in lower required minimum distributions than the Uniform Lifetime Table.

The new mortality tables (Single Life and Joint & Last Survivor Life Expectancy) may also be used to determine a plan owner's life expectancy (Single Life) or the Joint Life and Last Survivor Expectancy of a plan owner and designated beneficiary to calculate the amount of substantially equal periodic payments under I.R.C. §72(t)(2)(A)(iv). The substantially equal periodic payment rules are covered later in this chapter.

The series of substantially equal periodic payments under I.R.C. §72(t)(2)(A)(iv) will not be considered to have been modified because of the use of the new mortality table in 2002 and later years rather than the old tables used for 2001 and earlier years.

OVERVIEW OF THE "FINAL" REGULATIONS

Note. Since distributions for 2002 can be calculated (to varying degrees) under either the 1987, 2001, or 2002 "final" regulations, the following discussion and examples focus on the 2002 "final" regulations only. The "final" regulations are beneficial to those plan owners who desire lower annual "required minimum distributions."

Distributions During the Plan Owner's Lifetime

Generally, the first required minimum distribution must be taken by April 1 of the year after a person turns age 70½.

Example 9. Jim was born February 1, 1932. He turned age 70½ on August 1, 2002. He retired from his job when he turned age 65. He must take his first required minimum distribution by April 1, 2003.

There are exceptions to the general rule:

Example 10. Susan was born February 1, 1932. She turned age 70½ on August 1, 2002. She enjoys her job and can't picture retiring for several more years. She does not have any ownership in her company. Her retirement savings are in a company plan. She must take her first required minimum distribution by April 1 of the year after the year she **actually** retires.

Example 11. Mark was born February 1, 1932. He turned 70½ on August 1, 2002. All of his retirement savings are in a **Roth IRA**. **No distributions are required.**

Observation. Nothing in the new rules changes the fact that a person is allowed to withdraw, without penalty, any amount once he/she reaches the age of 59½.

With the new rules, only Table III — Uniform Lifetime Table is used. In most cases, all that is needed is the age of the retiree. The calculation is done by dividing the account balance at the end of the previous year by the applicable divisor from the table (based on the owner's age at the end of the distribution year). This amount will be the required minimum distribution. The only exception to the use of Table III — Uniform Lifetime Table is the situation where the sole beneficiary is a spouse who is more than 10 years younger than the plan owner. In this case, and only by choice of the plan owner, Table II — Joint and Last Survivor Expectancy Table can be used. The use of Table II — Joint and Last Survivor Expectancy Table compared to the use of the Table III — Uniform Lifetime Table will result in lower required minimum distributions.

Example 12. On December 31, 2001, the balance in Bill's IRA was $335,000. Bill turned 70½ in October 2002, so he is required to make a minimum distribution. He uses Table III — Uniform Lifetime Table (see partial table below). His divisor is 27.4 since he will still be 70 at the end of 2002. Therefore, by April 1, 2003, he must withdraw $12,226 ($335,000 ÷ 27.4).

Uniform Lifetime (partial)

Age of the Employee	Distribution Period
70	27.4
71	26.5
72	25.6
73	24.7

Observation. The December 31, 2001 balance is used for the calculation since Bill reached age 70½ in 2002. Deferring the first distribution until April 1, 2003, does not change the retirement account valuation date.

For each distribution year, the previous year's ending account balance must be determined. The owner's age at the end of the distribution year and Table III are used to determine the divisor. The balance is divided by the divisor. The result is the required minimum distribution for the year.

Note. In effect, everyone will now use the recalculation method, for distributions during the owner's lifetime.

If there are more than 10 years difference in age between spouses, and the spouse is the sole beneficiary, the required minimum distribution will be reduced by using Table II — Joint and Last Survivor, which can be found in Appendix A at the end of this chapter. This option is **only** available for spouses who are more than 10 years younger.

Example 13. Using the same facts in **Example 12**, Bill will be 70 at the end of 2002 and his wife, Kay will be 52. Bill chooses to use Table II - Joint and Last Survivor Expectancy (see partial table below) for calculating his required minimum distribution. The divisor is 33.4. Therefore, by April 1, 2003, he must withdraw $10,030 ($335,000 ÷ 33.4).

Joint and Last Survivor Expectancy (partial)

AGES	50	51	52	53	54	55	56	57	58	59
50	40.4	40.0	39.5	39.1	38.7	38.3	38.0	37.6	37.3	37.1
51	40.0	39.5	39.0	38.5	38.1	37.7	37.4	37.0	36.7	36.4
52	39.5	39.0	38.5	38.0	37.6	37.2	36.8	36.4	36.0	35.7
53	39.1	38.5	38.0	37.5	37.1	36.6	36.2	35.8	35.4	35.1
54	38.7	38.1	37.6	37.1	36.6	36.1	35.7	35.2	34.8	34.5
55	38.3	37.7	37.2	36.6	36.1	35.6	35.1	34.7	34.3	33.9
56	38.0	37.4	36.8	36.2	35.7	35.1	34.7	34.2	33.7	33.3
57	37.6	37.0	36.4	35.8	35.2	34.7	34.2	33.7	33.2	32.8
58	37.3	36.7	36.0	35.4	34.8	34.3	33.7	33.2	32.8	32.3
59	37.1	36.4	35.7	35.1	34.5	33.9	33.3	32.8	32.3	31.8
60	36.8	36.1	35.4	34.8	34.1	33.5	32.9	32.4	31.9	31.3
61	36.6	35.8	35.1	34.5	33.8	33.2	32.6	32.0	31.4	30.9
62	36.3	35.6	34.9	34.2	33.5	32.9	32.2	31.6	31.1	30.5
63	36.1	35.4	34.6	33.9	33.2	32.6	31.9	31.3	30.7	30.1
64	35.9	35.2	34.4	33.7	33.0	32.3	31.6	31.0	30.4	29.8
65	35.8	35.0	34.2	33.5	32.7	32.0	31.4	30.7	30.0	29.4
66	35.6	34.8	34.0	33.3	32.5	31.8	31.1	30.4	29.8	29.1
67	35.5	34.7	33.9	33.1	32.3	31.6	30.9	30.2	29.5	28.8
68	35.3	34.5	33.7	32.9	32.1	31.4	30.7	29.9	29.2	28.6
69	35.2	34.4	33.6	32.8	32.0	31.2	30.5	29.7	29.0	28.3
70	35.1	34.3	33.4	32.6	31.8	31.1	30.3	29.5	28.8	28.1
71	35.0	34.2	33.3	32.5	31.7	30.9	30.1	29.4	28.6	27.9
72	34.9	34.1	33.2	32.4	31.6	30.8	30.0	29.2	28.4	27.7
73	34.8	34.0	33.1	32.3	31.5	30.6	29.8	29.1	28.3	27.5

DETERMINATION OF DESIGNATED BENEFICIARY

Note. To compute **required minimum distributions for 2002**, beneficiaries may rely on **either** the "final" regulation (**April 2002**), the **2001** "revised" proposed regulations, or the **1987** "proposed" regulations. Designated beneficiaries who have been receiving required minimum distributions over their life expectancy may now switch to the new Table I — Single Life Expectancy Table for **2002**. In **2003**, the switch will be **required**.

It is now possible to allow a change of beneficiary during the lifetime of the owner without also requiring an increase in the distribution amount. Under the old rules, a switch to a beneficiary with a shorter life expectancy also required a larger distribution amount because one determining factor was the age of the beneficiary.

The determination of a beneficiary can now be made by September 30th of the year following the year of death of the employee or IRA owner. Obviously, the deceased will not return from the grave to make the decision, but the regulation allows for some other possibilities.

After the death of the plan owner, the beneficiary can be changed in the event one or more of the beneficiaries either disclaim (choose to not be a beneficiary) or cash out. Formerly, the beneficiary needed to be determined by the time the required distributions began. It is important to note changes are dependent upon choices made by the existing beneficiaries, and not by the inclusion of previously unnamed beneficiaries.

Distributions After The Plan Owner's Death

Under the new rules, if the designated beneficiary of the plan owner is an individual, such as a spouse or child, minimum required distributions for years after the year of the plan owner's death generally are based on a term certain distribution period. This is determined using the beneficiary's single life expectancy (Table I — Single Life Expectancy). This rule applies whether or not the death occurred before the plan owner's required beginning date. **If the plan owner's beneficiary is not an individual** (i.e. the beneficiary is the estate), the rule for determining minimum required distributions for years after the plan owner's death depends on whether or not the death occurred before the plan owner's required beginning date.

The Plan Owner's Designated Beneficiary Is — *An Individual*

To figure the minimum required distribution for 2002, divide the account balance at the end of 2001 by the distribution period from Table I — Single Life Expectancy. Determine the distribution period as follows:

Spouse as Sole Designated Beneficiary

The distribution period is the divisor listed in Table I next to the spouse's age in **each distribution year** (recalculation). If the plan owner died before the year in which he/she attained age 70½, distributions to the spouse are not required to begin until the year the plan owner would have attained age 70½.

Other Designated Beneficiary

In general, the distribution period is the divisor listed in Table I (Single Life Expectancy), next to the beneficiary's age (as of his/her birthday in the year following the year of the plan owner's death), **reduced by one** (term certain) for each elapsed year since the year following the plan owner's death. However, if the plan owner died after the required beginning date (70½), the designated beneficiary has the option of taking required minimum distributions over the **longer of:**

1. the life expectancy of the designated beneficiary (Table I — Single Life Expectancy Table); or
2. the remaining life expectancy of the plan owner (Table I — Single Life Expectancy Table).

Note. The choice given above to a designated beneficiary where the plan owner died after the required beginning date is a result of the final regulations, since no provision for this option existed under the 1987 or 2001 proposed regulations.

Example 14 (New Law). Brad dies at age 68 in 2002; his beneficiary is his daughter, Sara, age 40. The distributions will be calculated over her single life expectancy with Table I. Using Table I, Sara's age would be calculated as of the year after Brad's death (41 in this case). The Table I — Single Life Expectancy divisor for a 41-year old is 42.7. If Brad's IRA balance on December 31, 2002 was $335,000, Sara would have to take a required minimum distribution of $7,845 in 2003 ($335,000 ÷ 42.7). Thereafter, she would reduce the original divisor by one for each subsequent year, and divide it into the previous year's December 31 IRA balance.

The Plan Owner's Beneficiary Is — *Not An Individual*

Determine the minimum required distribution for 2002 as follows:

Death on or After the Required Beginning Date

Divide the account balance at the end of 2001 by the distribution period from Table I — Single Life Expectancy. The distribution period is the divisor listed next to the plan owner's age (as of his/her birthday in the year of death), reduced by one for each elapsed year since the year of death.

Death Before the Required Beginning Date

The 5-Year Rule continues to apply. Under this rule, the entire account must be distributed by the end of the fifth year following the year of the plan owner's death. No distribution is required for the years before the fifth year. This rule may also be elected by a beneficiary who is an individual.

Observation. A significant advantage of the "final" regulations is the elimination of the possibility the entire balance of the account must be distributed by December 31 of the year following the plan owner's death.

Example 15. Chris dies at age 75; his beneficiary is his **estate** rather than an individual. Since he died after his required beginning date, **his age** is used to calculate subsequent distributions. The divisor for age 75 is 13.4 (see partial Table I below). Distributions will be as follows, assuming an account balance of $200,000. Note the divisor decreases by one each year.

Year 1: $200,000 ÷ 12.4 = $16,129
Year 2: $183,871 (+ 13,000 gains) = $196,871 ÷ 11.4 = $17,269
Year 3: $179,602 (– 32,000 losses) = $147,602 ÷ 10.4 = $14,192

Follow the same pattern for all subsequent years.

Single Life Expectancy

Age	Divisor
73	14.8
74	14.1
75	13.4

Note. Distributions begin the year after death using the owner's/employee's age in the year of death reduced by one each year [Reg. 1.401(a)(9)-5, A-5(c)(3)].

Example 16. Bob dies at **age 65**; his beneficiary is his **estate**. Since he died before beginning his required distributions, the **entire account balance must be withdrawn by December 31 of the fifth year** after the year of his death.

Observation. As a practical matter, when the 5-Year Rule applies, the withdrawals can happen in any manner at any time during the period. The only requirement is all money must be withdrawn by the deadline.

The above rules apply if there is no provision in the plan to specify the method of distribution after the death of a plan owner. However, there are optional plan provisions that allow an election of the 5-Year Rule by the plan owner or the beneficiary [Reg. §1.401(a)(9)-3(A-4)].

The plan may adopt a provision specifying that:

- The 5-Year Rule will apply to certain distributions after the death of a plan owner even if the plan owner has a designated beneficiary, and
- Distribution in every case will be made in accordance with the 5-Year Rule.

A plan is not required to have the same method of distribution of the benefits for all plan owners.

A plan may adopt a provision that permits owners (or beneficiaries) to elect, on an individual basis, whether the 5-Year Rule or the Life Expectancy Rule applies to distributions after the death of a plan owner who has a designated beneficiary. Such an election must be made no later than the earlier of:

1. The end of the calendar year in which the distribution would be required to commence in order to satisfy the requirements for the Life Expectancy Rule, or
2. The end of the calendar year that contains the fifth anniversary of the date of death of the plan owner.

As of the date determined under the Life Expectancy Rule, the election must be irrevocable for the beneficiary (and all subsequent beneficiaries) and must apply to all subsequent calendar years. If a plan provides for the election, the plan may also specify the method of distribution that applies if neither the plan owner nor the beneficiary make the election. If neither elect a method and the plan does not specify which method applies, distribution must be made as if there was no plan provision.

Example 17. Scott's pension plan specifies that he or his beneficiary can elect whether to use the 5-Year Rule or the Life Expectancy Rule. When he dies at age 72, his beneficiary is his son, Donald. If Scott has not elected which method to use, Donald must make that choice by December 31 of the next year, since that would be the earlier of the two test dates. If Donald doesn't make a choice by that date, the "no plan provision" rules go into effect. In this case, the distributions will be made under the Life Expectancy Rule, since there is a designated beneficiary.

IRA Reporting of Required Minimum Distributions

Reg. §1.408-8, Q&A-10, of the new regulations states the trustee of an IRA is required to report information, regarding the amount required to be distributed from the IRA for each calendar year, to individuals or entities, at the time, and in the manner, prescribed by the Commissioner in the revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin as well as in federal tax forms and accompanying instructions.

Cumulative Bulletin Notice 2002-27, IRB 2002-18 (April 16, 2002) was issued as a result of the regulations, and provides guidance on the reports that trustees, custodians, and issuers are required to make regarding required minimum distributions from individual retirement accounts and annuities (IRA's).

Note. Although reporting of a required minimum distribution applies for each IRA, the IRA owner may take the required minimum distribution from another of his/her IRAs to the extent permitted under Q&A 9, Reg. 1.408-8.

Required Reporting to the IRA Owner

If a minimum distribution is required for an IRA and the IRA owner is alive at the beginning of the year, the trustee that held the IRA as of December 31 of the prior year must provide a statement to the IRA owner by January 31. This statement must be in accordance with one of the two alternatives listed below. This requirement is effective beginning with required minimum distributions for 2003. The first reports are due January 31, 2003.

Alternative one. An IRA trustee furnishes the IRA owner with a statement of the amount of the required minimum distribution and the date the amount must be distributed. The amount is permitted to be calculated assuming the sole beneficiary of the IRA is not a spouse more than 10 years younger than the IRA owner and that no amounts received by the IRA after December 31 of the prior year are required to be taken into account to adjust the value of the IRA as of December 31 of the prior year for purposes of determining the required minimum distribution pursuant to Q&A-7 or Q&A-8 of Reg. §1.408-8.

Alternative two. An IRA trustee provides a statement to the IRA owner that:

A. Informs the owner that a minimum distribution for the IRA is required for the calendar year and the date the amount must be distributed, and

B. Includes an offer to furnish the owner, upon request, with a calculation of the amount of the required minimum distribution for the IRA for that calendar year.

- If the owner requests the calculation, the trustee must calculate the required minimum distribution and report it to the IRA owner.

Beginning in 2004, under both alternatives, a statement from the trustee must inform the IRA owner that the IRS will be notified about the owner's required minimum distribution. The statement can be provided to the IRA owner in conjunction with the statement of the fair market value of the IRA as of December 31 of the prior year that is otherwise required to be provided to the IRA owner by January 31 of a year.

Required Reporting to the IRS. Beginning with required minimum distributions for calendar year 2004, if a minimum distribution is required , the IRA trustee must indicate that a minimum distribution is required (but need not indicate the amount) on Form 5498, IRA Contribution Information, for the preceding year (i.e. on a 2003 Form 5498 for a 2004 required minimum distribution) in accordance with the instructions for Form 5498.

No Reporting for I.R.C. §403(b) Contracts and IRAs of Deceased Owners. Reg. §1.403(b)-3 provides that an I.R.C. §403(b) contract is treated as an individual retirement plan for purposes of satisfying the required minimum distribution rules. Consequently, the delegation of authority to require reporting for IRAs also applies to I.R.C. §403(b) contracts. However, **no reporting** is required for required minimum distributions from I.R.C. §403(b) contracts.

Reporting is not required for deceased IRA owners. Also, no reporting is required for Roth IRAs, since there are no lifetime minimum distributions required for Roth IRAs.

Application for Years After 2003. This notice provides the reporting rules for required minimum distributions for calendar year 2003. For required minimum distributions for calendar years after 2003, these rules apply except to the extent modified in Federal tax forms and accompanying instructions.

CHOOSING A BENEFICIARY

With the final regulations eliminating beneficiary concerns for calculating lifetime distributions, an IRA owner might make the mistake of deciding that a beneficiary is not important. However, having a designated beneficiary affects how soon distributions are made after the death of the IRA owner, and is still vital for good estate planning.

WHAT IS A DESIGNATED BENEFICIARY?

The designated beneficiary must be an individual who is entitled to all or part of the benefit, contingent upon the death of the IRA owner. The terms of the plan may specify that the beneficiary or the owner or his/her surviving spouse can make that determination. The key is the word "designation" [Prop. Reg. §1.401(a)(9)-4(A-1)].

A designated beneficiary is not required to be specified by name in the plan, or by the owner, in order to be a designated beneficiary, provided the individual is identifiable September 30 of the year following the year of the owner's death. If possible, the members of a class of beneficiaries capable of expansion or contraction will be treated as being identifiable as of the date the beneficiary is determined, to identify the class member with the shortest life expectancy. The fact that an owner's interest under the plan passes to a certain individual under applicable state law does not make that individual a designated beneficiary unless the individual is designated as a beneficiary under the plan.

Note. A beneficiary named through an estate, either under the owner's will or by state law, **cannot** be a designated beneficiary for required minimum distribution purposes.

Example 18. Richard is an employee of XYZ Company, which offers a pension plan. When he turns 65, he selects the option of receiving his distribution as a joint and survivor annuity over his life and that of his son, Paul. Paul must be named as a beneficiary of Richard's plan, either by name or category (i.e., children), for him to be a designated beneficiary.

Observation. In most cases, an annuity distribution, established before the required beginning date, will continue unchanged when the employee reaches the age of $70^1/_2$, because single or joint life annuities normally meet the life expectancy requirements.

Example 19. Juanita never saw any need to name a beneficiary for her IRA. She didn't have any close relatives and never really got to know any more distant family members. When she died, the state determined her beneficiary to be her second cousin, Jose. For purposes of determining the minimum distribution period, there is no designated beneficiary.

Example 20. When Judy established her IRA, she knew that she wanted to leave something to her brother's children, so she designated them as her beneficiaries. At the time there were only three children, but a fourth was born later. This is considered an expandable class, and the new child is a designated beneficiary.

Observation. Many plans require specific identification of beneficiaries. In that case, Judy would need to inform her plan administrator in order to add another beneficiary.

WHEN A DESIGNATED BENEFICIARY IS DETERMINED

The determination is made as of September 30 of the year following the year of death. This makes it possible to "clean up" the beneficiary designations in the event that some of the multiple designations are no longer desired. Since the age of the oldest designated beneficiary determines the payout rate, the account can be preserved for the longest possible period.

Reg. §1.401(a)(9)-4(A-4) states:

General rule . . . The employee's designated beneficiary will be determined based on the beneficiaries designated as of the date of death who remain beneficiaries as of September 30 of the calendar year following the calendar year of the employee's death. Consequently, except as provided in 1.401(a)(9)-6T, any person who was a beneficiary as of the date of the employee's death, but is not a beneficiary as of that September 30 (e.g., because the person disclaims entitlement to the benefit in favor of another beneficiary or because the person receives the entire benefit to which the person is entitled before that date), is not taken into account in determining the employee's designated beneficiary for purposes of determining the distribution period for required minimum distributions after the employee's death.

Example 21. John dies March 15, 2002. The beneficiaries of his IRA are his two daughters, Kristen, age 47, and Keryn, age 27. Kristen is always in money trouble and currently is in danger of losing her house. She doesn't want to receive an annual distribution but instead wants her money now. The value of the IRA is determined and Kristen gets her half in cash. Because she received her cash before September 30, 2003, she is no longer a designated beneficiary. This means the IRA distribution schedule is based on Keryn's age.

Example 22. Billie dies December 15, 2002. The beneficiaries of her retirement plan are her 3 children, Rich, Gary and Don. Don is a major rock star, earning in excess of $20 million per year while his two brothers have never amounted to much. Don formally disclaims the inheritance in January 2003, leaving Rich and Gary as the only designated beneficiaries.

The requirements for a formal disclaimer are given in I.R.C. §2518. To be valid, a disclaimer must be:

- An irrevocable and unqualified refusal to accept property;
- In writing; and
- Made within nine months after death.

The disclaiming party cannot:

- Benefit from the property; or
- Designate who gets the property being disclaimed.

DESIGNATED BENEFICIARY OLDER THAN ACCOUNT OWNER

If the account owner dies after the required beginning date (generally, April 1 of the year after the year the owner reaches age $70^1/_2$), the final regulations allow a designated beneficiary who is older than the owner to receive required minimum distributions over the **owner's remaining life expectancy**, rather than over the beneficiary's shorter life expectancy.

BENEFICIARIES SWITCH FROM 5-YEAR RULE TO LIFE EXPECTANCY METHOD

The final regulations allow beneficiaries who have been subject to the 5-Year Rule, either by affirmative election or default, to switch to the life expectancy method (Table I), if the plan allows the switch and the 5-year distribution period has not ended.

Any distribution required for prior years under the life expectancy method that has not yet been taken must be received by the earlier of December 31, 2003 or the end of the 5-year period (December 31 of the fifth year after the year of the owner's death).

Example 23. John died in 1999 at the age of 65, leaving an IRA of $300,000 to his estate. His only daughter, Irene, was the sole heir to the estate. Irene is subject to the 5-year required minimum distribution period, but to date (2002) has taken no distributions. Irene can use the life expectancy method if she takes the distributions that would have been payable to her for previous years by December 31, 2003.

SPOUSE AS BENEFICIARY

In many cases, the individual chooses to make his/her spouse the beneficiary. For an IRA, the spouse has the option to either postpone receiving distributions until the year the deceased spouse would have turned $70^1/_2$, or to make the IRA his/her own. Under the proposed regulations, the election to make the IRA the beneficiary's own **is deemed made** when he/she either contributes to the IRA or fails to take a required distribution. The final regulations include these two points, in addition to the points listed below.

Example 24. Kyle dies at age 72. His wife, Charlene, is the beneficiary of his IRA. Charlene is age 62 and financially secure. Because Charlene is the spouse, she can elect to consider the IRA as her own, and no distributions will be required until she is $70^1/_2$.

Under the "final" regulations, the deemed election rules are clarified as follows:

- Any required distribution for the year of death must be made before the deemed election.
- The election can be made at any time after the IRA owner's date of death.
- Spouse must be the sole beneficiary.
- Spouse must have unlimited right to withdraw from the account.

Example 25. Using the facts in **Example 24**, Kyle died at age 73. If Charlene wants to consider the IRA as hers, Kyle's required minimum distribution for the year must first be withdrawn.

Example 26. Instead of using the deemed election rules, Charlene has the option of rolling over the IRA account into her own name. In this circumstance, Kyle's required minimum distribution for the year must be withdrawn and is not eligible to be rolled over.

RULES FOR MULTIPLE BENEFICIARIES

Under the "final" regulations, distributions after the owner's death are made over the life of the designated beneficiary. When there is more than one beneficiary, the age of the oldest beneficiary is used to determine the required minimum distribution.

Example 27. Slocom dies at age 75, leaving his IRA to his children, Angel, age 29, Willhout, age 34, and Slim, age 39. The balance in the account on December 31 of the year of Slocom's death (after his final required distribution) is $700,000. Because Slim is the oldest, his life expectancy is used to determine the distribution of $16,055 ($5,352 per beneficiary) as follows (for 2003):

1. $700,000 (December 31, 2002 balance)
2. 43.6 (divisor for age 40, Slim's age the year after his father's death)

Single Life Expectancy

Age	Divisor
30	53.3
31	52.4
32	51.4
33	50.4
34	49.4
35	48.5
36	47.5
37	46.5
38	45.6
39	44.6
40	43.6

TAX PLANNING FOR MULTIPLE BENEFICIARIES

The age of the oldest beneficiary determines the distribution amount, and it cannot be changed once it has begun. If in **Example 27**, the oldest son dies at age 50, the distributions will continue to be paid out over his remaining life expectancy. Although nothing can be done about the distribution period once it has begun, there is tax planning that offers a more beneficial time period for beneficiaries of varying ages.

Example 28. Slocom could have established three different IRAs and made each child a beneficiary of one. That would give Slim a required minimum distribution of $5,352, Willhout, $4,811, and Angel, $4,378. The required distribution amounts were determined by dividing the $700,000 value by 3 and then dividing that amount ($233,333) by the divisor from the Table I — Single Life Expectancy for each age category (ages 30, 35, and 40).

An alternative to separate IRAs is to use sub-accounts, defined in Reg. §1.401(a)(9)-8(A-3).

For purposes of Section 401(a)(9), 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. The separate accounting must allocated all post-death investment gains and losses, contributions, and forfeitures, for the period prior to the establishment of the separate accounts on a pro rata basis in a reasonable and consistent manner among the separate accounts. However, once the separate accounts are actually established, the separate accounting can provide for separate investments for each separate account under which gains and losses from the investment of the account are only allocated to that account, or investment gain or losses can continue to be allocated among the separate accounts on a pro rata basis. A separate accounting must allocated any post-death distribution to the separate account of the beneficiary receiving that distribution.

Example 29. In establishing his IRA beneficiaries, Slocom gives $^1/_3$ of the gains, losses, contributions, and forfeitures to each of his three children. The required minimum distributions can now be calculated based upon the age of each beneficiary. If he simply lists the three children as his beneficiaries without specifying the percentage, the age of the oldest must be used for all three.

Example 30. Using the same situation as **Example 27**, Slocom dies, leaving his IRA to his three children. They can choose to split the IRA into separate accounts as long as they do it before December 31 of the year after Slocom dies, if that option is permitted by the IRA contract.

CONTINGENT BENEFICIARIES

As a matter of good planning, it is important to have one or more contingent beneficiaries, in the event the chosen beneficiary dies before the death of the IRA owner/employee. Whether or not to consider the contingent beneficiary depends upon timing.

Example 31. Ray names his daughter, Julie, as his primary beneficiary for his IRA. If Julie dies before she receives the entire amount, her daughter Kate becomes the beneficiary. Ray dies in 2001.

The IRA will be distributed using the Table I — Single Life Expectancy divisor for Julie as of September 30, 2002. If Julie dies after she starts receiving the distributions, Kate will continue to receive distributions at the same rate. This is because Kate's receiving the distributions is **contingent** upon Julie's death.

Example 32. The facts are the same as **Example 31**, except the primary beneficiary, Julie, dies prior to September 30, 2003. Because the determination of beneficiary is not made until September 30 of the year following the death of the IRA owner, Kate is no longer a contingent beneficiary but, instead, is the primary beneficiary. As a result, the distributions are figured over Kate's life expectancy.

> **Observation.** The concern about designated, contingent, and multiple beneficiaries is only relevant when they opt to take periodic distributions. If a beneficiary chooses to take all the money at once, the required minimum distribution is not an issue.

A TRUST AS THE BENEFICIARY

The "final" regulations specify that the designated beneficiary must be an individual. A non-designated beneficiary is limited in two ways:

1. If distributions have already begun, the amount cannot be changed.
2. If distributions have not begun, the entire account must be withdrawn by December 31 of the fifth year after the year of death.

Many times good tax planning calls for the creation of a trust, and a trust cannot be considered an individual. There is, however, a provision in the proposed regulations that allows the beneficiaries of a trust to be considered the designated beneficiaries for an IRA or employee plan. The key is to meet the requirements of Reg. §1.401(a)(9)-4(A-5), as listed below:

- The trust is a valid trust under state law, or would be but for the fact that there is no corpus.
- The trust is irrevocable or will, by its terms, become irrevocable upon the death of the employee.
- The beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the employee's benefit are identifiable from the trust instrument.
- Required documentation has been provided to the plan administrator.

Example 33. Randy has 10 grandchildren, ranging in age from 18 to 30. He set up a testamentary trust (one that begins after his death) with all the grandchildren named as beneficiaries. His IRA will be used to fund the trust, so the trust is the beneficiary of the IRA. Randy dies in 2002 at age 80. If Randy meets all of the requirements, his IRA will be distributed to the trust over the life of his oldest grandchild. If he does not meet the requirements, the IRA will be distributed by reducing Randy's life expectancy divisor by one each subsequent year until it is completely distributed.

Example 34. Using the same facts as **Example 33**, assume Randy died at age 68. In that case, he would not have started to receive his required distributions. If Randy meets all of the requirements, his IRA will be distributed to the trust over the life of his oldest grandchild. If he does not meet the requirements, the IRA must be withdrawn by December 31, 2007, under the 5-Year Rule.

Documentation Required

The employee or IRA owner must do one of the following:

A. Provide to the plan administrator a copy of the trust instrument and agree that if the trust instrument is amended at any time in the future, he/she will, within a reasonable time, provide a copy of each such amendment, or

B. Meet all of the following requirements:

1. Provide to the plan administrator a list of all the beneficiaries of the trust, including contingent and remainder beneficiaries, with a description of the conditions on their entitlement;
2. Certify that, to the best of his/her knowledge, this list is correct and complete;
3. Agree that, if the trust instrument is amended at any time in the future, he/she will, within a reasonable time, provide to the plan administrator corrected certifications to the extent that the amendment changes any information previously certified; and
4. Agree to provide a copy of the trust instrument to the plan administrator upon demand.

After the death of the IRA owner, the trustee of the trust has until October 31 of the year after the year of death to do one of the following:

1. Provide the plan administrator with a final list of all beneficiaries of the trust (including contingent and remainder beneficiaries with a description of the conditions on their entitlement) as of September 30 of the year following the year of the IRA owner's death; certify that, to the best of the trustee's knowledge, this list is correct and complete; and agree to provide a copy of the trust instrument to the plan administrator upon demand, or

2. Provide the plan administrator with a copy of the actual trust document for the trust that is named as a beneficiary of the employee under the plan as of the employee's date of death.

What Happens if There Is a Discrepancy?

If there is a discrepancy between the actual trust instrument and the certifications or earlier trust instruments, the use of the beneficiaries of the trust as designated beneficiaries of the IRA or employee plan will not automatically be disallowed. In order to keep their status as designated beneficiaries, there are two further requirements.

1. The plan administrator must have reasonably relied on the information provided, and

2. The required minimum distributions for calendar years after the calendar year in which the discrepancy is discovered are determined based on the actual terms of the trust instrument.

In the event that excise tax is due, the amount will be figured based on the actual terms of the trust in effect during the year. The excise tax is discussed later in this chapter.

Qualified Terminable Interest Property (QTIP) Trust

A QTIP trust is one that meets two requirements:

1. The surviving spouse must be entitled to receive all income from the property for life, payable at least annually.

2. No person can have the power to give the property to anyone other than the surviving spouse.

The QTIP trust restricts the spouse's ability to dispose of the property. Its purpose is to protect the assets from a spouse who is not able to manage them, to protect the assets from the surviving spouse's creditors, or, most commonly, to guarantee the ultimate disposition of the assets to a remainder beneficiary. When a person has children from a first marriage, he/she might opt for a QTIP trust to provide income for the spouse of the second marriage while still assuring that the assets will go to the children of the prior marriage. From an estate planning viewpoint, the QTIP trust allows the property to qualify for the marital deduction without having to give the spouse complete control of the asset.

In Rev. Rul. 2000-2, 2000-3 IRB, the IRS concluded the executor of the estate could make the QTIP election for an IRA that named a trust as the beneficiary. The trust met all of the QTIP requirements. The decedent's surviving spouse could compel the trustee to withdraw from the IRA an amount equal to all the income earned on the assets held in the IRA and pay that amount to the surviving spouse at least annually.

The proposed regulations have incorporated Rev. Rul. 2000-2 for beneficiaries and required distributions, making a distinction between trusts with multiple beneficiaries and those with just one.

> **Example 35.** Bob made his testamentary trust the beneficiary of his estate and his wife, Debbie, the beneficiary of the trust. When Bob dies, the trustee is to distribute all income from the trust annually to Debbie. After her death, the assets will go to Bob's three children. The trust meets all of the QTIP requirements. Since Debbie is the sole beneficiary, the trustee can elect to wait until the year Bob would have turned 70½ before beginning to take the distributions. When required minimum distributions begin, they will be calculated over Debbie's life expectancy.

Example 36. If Bob, in **Example 35**, had specified that Debbie would receive the required minimum distribution each year and the rest of the income would be accumulated for the benefit of his children as remainder beneficiaries, the rules change. Debbie is not considered the sole beneficiary, even though the children can't get the money until after Debbie dies. She can no longer qualify to wait until the year Bob would have turned $70^1/_2$ to begin distributions; instead, they must begin by the end of the year after his death. As in **Example 35**, they will be calculated over her life expectancy, assuming she is the oldest beneficiary.

QUALIFIED DOMESTIC RELATIONS ORDER (QDRO) RULES

The rules for a QDRO were established in the 1987 proposed regulations and have not been changed. A QDRO is defined in I.R.C. §414(p) as a decree, order, or property settlement under state law relating to child support, alimony, or marital property rights that assigns part or all of a participant's plan benefits to a spouse, former spouse, child, or other dependent of the participant. The major points of those rules are summarized below:

- The former spouse is treated as a spouse (including being a surviving spouse, if applicable) even if the QDRO does not specifically provide for spousal treatment.
- The rule applies no matter how many former spouses qualify.
- Required minimum distributions to the former spouse must begin by the employee's required beginning date.
- The required minimum distribution for the former spouse may be determined based upon the age of the employee in the distribution calendar year or, if the age difference between them is more than 10 years, on the joint life expectancy of the employee and the former spouse.

The new regulations also allow a delay for a period of up to 18 months in the required minimum distribution if there is an amount segregated in connection with the review of a QDRO under I.R.C. §414(p)(7).

TYPES OF RETIREMENT PLANS

Over the course of their working lives, taxpayers participate in a variety of retirement plans. One company might offer a defined benefit plan, another may offer a profit sharing plan. Some offer no plan at all, and the only option available is an individual retirement arrangement (IRA). This section takes a closer look at each type of plan to see how the "final" regulations affect it.

DEFINED CONTRIBUTION PLANS

In a defined contribution plan, each employee has an individual account established for him/her that is maintained by the employer. The benefit payments are based on the total amount in the account at the time of retirement. Defined contribution plans are of three principal types:

- **Money Purchase Plan.** The employer is required to contribute a stated percentage of the participant's compensation annually.
- **Target Benefit Purchase Plan.** This is similar to a money purchase plan except that the participant's age is taken into account in determining the contribution percentage.
- **Profit Sharing Plan.** There is no stated contribution percentage; instead, it is determined annually and, in some cases, there is no contribution at all. Plans with employee contributions (and often an employer match) fall into the categories of thrift savings or 401(k) plans.

> **Note.** The new rules for required minimum distributions from defined contribution plans are found in Reg. §1.401(a)(9)-5.

General Rule

The required minimum distribution is determined by dividing the account by the applicable distribution period. The distribution period is the divisor from Table III — Uniform Lifetime unless the spouse is the sole beneficiary and is more than 10 years younger than the employee. In this case, Table II — Joint and Last Survivor Expectancy may be used. The required minimum distribution, however, can never exceed the vested account balance on the date of the distribution. Under I.R.C. §401(a)(9)(A)(ii), the entire interest of an employee in a qualified plan must be distributed, beginning not later than the employee's required beginning date, over the life of the employee or over the lives of the employee and a designated beneficiary (or over a period not extending beyond the life expectancy of the employee and a designated beneficiary).

Example 37. Susan, who is single, retired from ABC Company at age 65. She was fully vested in the 401(k) at the company. Because she wants to leave her estate to her two nephews, she took a minimal draw when she retired. Since she turns 70½ and 71 in the same year, she will need to divide the balance in her account by her divisor of 26.5 to ensure that she is withdrawing the required minimum distribution (see below).

Age of the Employee	Distribution Period
70	27.4
71	26.5
72	25.6

Distribution Date

For a non-owner employee, the required minimum distribution date depends upon when he/she actually retires. Normally the first distribution must be made by April 1 of the year after the employee turns 70½. A non-owner employee who continues to work beyond his/her seventieth birthday, however, can defer receiving the first distribution until April 1 of the year following actual retirement.

Example 38. Blake turns age 82 in 2002 and decides to retire. No matter when in the year he actually retires, he must take his first required minimum distribution by April 1, 2003. On the other hand, JoAnne, retired at age 65; she must take her first required minimum distribution by April 1 of the year after she turns 70½.

Observation. An employee who waits until April 1 to take his/her first required minimum distribution will then be in the position of having to take two distributions in one year. From a tax viewpoint, it might be advantageous to take the April 1 distribution before the end of the previous year. Just because the distribution can be delayed until the next year, does not necessarily mean it is a good idea to delay it.

Annuity Contracts

The employee has the option of purchasing an annuity contract from an insurance company using the entire proceeds of the individual account. In that case, the annuity payments will be used in lieu of the required minimum distribution amounts provided the provisions of Treas. Reg. §1.401(a)(9)-6 are met (see "Defined Benefit Plans" later in this chapter).

Observation. An employee can also purchase an annuity contract without using his/her entire account. In that case, the annuity account and the remaining defined contribution account will be treated separately. Each will have its own required minimum distribution.

Calculating the Account Value

Defined contribution plans are individual accounts, so the relevant account balance is the value at the end of the year before distributions must begin. Any contributions by the employee or forfeitures from other employees allocated after the end of the year to the previous year will increase the balance. Any allocated distributions will decrease it. Since the required minimum distribution for the first year can be delayed until April 1 of the year following the year a person turns $70^1/_2$, there will automatically be an adjustment if the distribution is delayed. When using the table to determine the distribution period during the lifetime of an employee, use his/her age in the year of the distribution requirement, not the year of the valuation. That would be the person's age at the end of the year in which he/she turned $70^1/_2$.

Example 39. Mina retires from ABC Co. She was a participant in the 401(k) plan and is fully vested. She has been taking irregular withdrawals until now. She turned $70^1/_2$ on March 1, 2002. On December 31, 2001, the value of her account was $75,000. No contributions, forfeitures, or distributions were allocated to her account in 2002 for the prior year. Her required minimum distribution is $2,830 ($75,000 ÷ 26.5, the distribution period for a person who is 71). This is true even though she elected to wait until April 1, 2003, to take the distribution.

Age of the Employee	Distribution Period
70	27.4
71	26.5
72	25.6
73	24.7
74	23.8
75	22.9

Example 40. In 2003, Mina, from **Example 39**, must take a required minimum distribution for 2003 in addition to the $2,830 distribution she took for 2002 on April 1, 2003. The distribution is treated as if it was made before the end of 2002. The proposed regulations required that the balance in the account at the end of 2002 be reduced by that distribution before calculating the 2003 required minimum distribution. However, **the final regulations no longer require that the April 1st distribution be subtracted from the December 31 balance of the prior year**.

Handling Distributions after the Employee Dies

If an employee dies on or after his/her required beginning date for distributions, the age-based divisor switches to that of the designated beneficiary, or is reduced by one each subsequent year if there is no designated beneficiary.

Example 41. Terri dies October 12, 2002, at the age of 72. Her designated beneficiary is her son, James. Terri's final distribution will be calculated using her age in the calendar year of her death. When the 2003 distribution is determined, James' age will be used to determine the required minimum distribution using Table I — Single Life Expectancy Table. In subsequent years, he will decrease his life expectancy divisor by one for each year since the death of Terri.

Example 42. Jack dies October 12, 2002, at the age of 72. Because he left his pension to his estate, he is not considered to have a designated beneficiary. The distribution for the year of Jack's death is computed using Table III — Uniform Lifetime Table. Distributions in the following year are computed using the single life factor for Jack's age in the year of his death, reduced by one each subsequent year until the entire pension is disbursed.

If the employee dies before his/her required beginning date, the age of the designated beneficiary is used to calculate the distributions, assuming there is a designated beneficiary.

Example 43. Juan dies October 12, 2002, at the age of 68. His designated beneficiary is his daughter, Kristina, age 34. Since the applicable date for determining the beneficiary is September 30, 2003, Kristina will use Table I — Single Life Expectancy to determine her divisor based upon her age as of that date. The divisor is 48.5 according to the table. In each subsequent year, she will reduce that divisor by one.

Single Life Expectancy

Age	Divisor
30	53.3
31	52.4
32	51.4
33	50.4
34	49.4
35	48.5

Example 44. Joe dies October 12, 2002, at the age of 68. His wife, Marge, is his sole designated beneficiary. Marge will not be required to draw any distributions until April 1, 2005, the year after the year that Joe would have turned 70½. She did not transfer the IRA to her own account.

Example 45. If Marge, in **Example 44**, dies in 2008, distributions continue over her life expectancy. Her daughter, Kay, becomes the beneficiary. Kay will use the factor for Marge's age as of the end of the year of her death and reduce the distribution period by one each year. Once the designated beneficiary starts receiving the benefits, the subsequent beneficiary continues with those payments.

If the employee dies before his/her required beginning date without designating a beneficiary, the 5-Year Rule applies.

Multiple Beneficiaries

Designated beneficiaries provide the pension plan a more beneficial treatment in terms of distribution time requirements, but **multiple** beneficiaries can confuse the issue. In general, the designated beneficiary with the shortest life expectancy, i.e., the oldest beneficiary, is the one used to determine the distribution period. All of the beneficiaries must qualify as designated beneficiaries, or the employee will be treated as having none.

Example 46. Carol designates her children, John, age 30, Sue, age 28, and Jessie, age 25, as her beneficiaries. Because John has the shortest life expectancy, his age is used to determine the required minimum distribution if Carol dies.

Example 47. Carol, in **Example 46**, gets some questionable financial advice and adds her estate to her list of beneficiaries. By including a non-designated beneficiary (the estate), all distributions must be made over the remainder of her life expectancy if she dies after her required beginning date, instead of over the much longer life expectancy of her oldest child.

The age of a contingent beneficiary is considered only if the contingency is not dependent upon the death of the employee or another beneficiary.

Example 48. Carol, in **Example 46**, designates her three children as beneficiaries. She also designates her 48-year-old physically handicapped brother, if his primary caregiver, Carol's mother, is unable to care for him. If Carol dies, the age of her brother must be used to calculate the required minimum distributions.

Example 49. If, in **Example 48**, Carol made her brother a beneficiary only in the event that one or more of her children died, his age would not be included in the required minimum distribution calculation if the children were all living on the required beginning date. The age of the oldest child, John, would be the relevant age. Even if John dies before the distribution period is complete, the distribution period will be unchanged.

Example 50. Referring to **Example 49**, if any of the children died before the required distributions began, her brother's age would become the one used to determine the required minimum redistribution.

DEFINED BENEFIT PLANS

Defined benefit plans provide a specific amount of benefit to an employee at retirement. A variety of formulas are used to determine the amount of the benefit. Typically, the formula uses the employee's earnings averaged over the number of years of employment. This type of plan generally provides for annuity distributions.

Requirements for Annuity Distributions

Annuity distributions must be paid in periodic payments at intervals not longer than one year. They can be paid over a single life or over a joint life expectancy. Once the distribution period has been established, it cannot be lengthened. According to Reg. §1.401(a)(9)-6T, the dollar amount of payments can be increased:

- With any percentage increase in a specified and generally recognized cost-of-living index;
- To the extent of the reduction in the amount of the employee's payments to provide for a survivor benefit upon death, but only if the beneficiary whose life was being used to determine the period described in I.R.C. §401(a)(9)(A)(ii) over which payments were being made dies or is no longer the employee's beneficiary under a qualified domestic relations order (QDRO) within the meaning of I.R.C. §414(p);
- To provide cash refunds of employee contributions upon the employee's death; or
- Because of an increase in benefits under the plan.

Distributions can be made under a life annuity, or joint and survivor annuity. Currently it is not a problem if distributions from a variable annuity increase due to the investment performance of the underlying assets, but that is an area that is still under study.

Annuity payments must begin on or before the employee's required beginning date and must match the stated intervals for payment. If that interval is annual, there will only be one required payment per year, but the payments can also be bimonthly, monthly, or semiannually.

If an annuity contract is purchased after the required beginning date, the first payment interval must begin on or before the purchase date.

Example 51. Sam, an unmarried participant in a defined benefit pension plan, turns 70½ in 2002. The plan provides for monthly annuity payments of $750 per month for life with a 10-year period certain. In order to meet the requirements, Sam must begin to draw the payments on or before April 1, 2003, and continue to receive the $750 monthly for the rest of his life. If he dies before March 2013, his beneficiary would receive the payments for the remainder of the 10 years.

Example 52. Sally participated in a profit sharing plan during her working career. When she was required to take minimum distributions, she calculated the amount each year and made timely withdrawals. At the age of 75, she decided to transfer all of the balance of her account into an annuity so that she no longer had to deal with the calculations. Assuming she purchased the annuity June 1, she can use any date between January 1 and June 1 as the starting date for her payment intervals. She will now be receiving a set amount at regular intervals.

Observation. If Sally does not receive her required minimum distribution for the current year due to selecting the annual option on June 1, she will still need to take the required minimum distribution for the prior year under the profit sharing plan. This is not a method for skipping a payment.

Life Annuity Limitations for Non-Spouse Beneficiaries

Payments made under a joint and survivor annuity with the spouse as the beneficiary can be 100% of the annuity payment payable to the employee no matter the age difference between the two. In this case, after the employee dies, his/her spouse can continue to receive the identical amount of payment. An employee who was receiving $300 per month can be assured that his/her survivor spouse will also receive $300 per month. If, however, the joint and survivor annuity has a non-spouse beneficiary who is more than 10 years younger than the employee, a separate table must be used to limit the payment. This is because the old minimum distribution incidental benefit (MDIB) rules are still in effect in this situation. The applicable percentage must be applied to any benefit increases as well as to the regular survivor benefits. If there is more than one beneficiary, the age of the youngest will be used to calculate the percentage. There is a new table that gives the percentage used to compute the allowable payment.

Example 53. Kyle is 65 years of age. After participating in his company's defined benefit plan during his working career, he is now ready to receive his retirement. Kyle's beneficiary is his 40-year-old daughter, Meghan. Under the terms of his plan, he will receive $800 per month until his death. After his death, Meghan will receive the monthly payments. Since Meghan is 25 years younger than Kyle, the MDIB rules (see partial table below) will only allow her to receive 66% of his payment, or $528, and the plan must be amended to include that provision.

Excess of Age of Employee Over Age of Beneficiary	Applicable Percentage
18	77%
19	75%
20	73%
21	72%
22	70%
23	68%
24	67%
25	66%

Period Certain

If an employee elects to take payments over his/her life, there is the potential for substantial lost wealth in the case of premature death. One way to prevent a loss is to take a lesser payment with the guarantee that payments will be received for a certain number of years even if the employee dies during that time. A period certain decision ensures an inheritance for the beneficiaries if the employee dies before the end of the period. However, there is a limit on the allowable period certain under an annuity contract, based upon the beneficiary and whether or not the required beginning date has passed.

Example 54. Todd and his wife, Kay, are both 71, and she is the sole beneficiary of Todd's annuity. The maximum period certain is based upon the joint life and last survivor expectancy of the two of them as of the required starting date, or 20.9 years.

Joint And Last Survivor Expectancy

Ages	65	66	67	68	69	70	71	72	73	74
68	25.0	24.5	24.0	23.5	23.1	22.7	22.3	22.0	21.6	21.3
69	24.6	24.1	23.6	23.1	22.6	22.2	21.8	21.4	21.1	20.8
70	24.3	23.7	23.2	22.7	22.2	21.8	21.3	20.9	20.6	20.2
71	23.9	23.4	22.8	22.3	21.8	21.3	20.9	20.5	20.1	19.7

Example 55. Jerry is single and his beneficiary is his son, Jerry, Jr. The maximum period certain is the lesser of Jerry's applicable distribution period in the year of the annuity start date, or the joint life and last survivor

expectancy of the two of them. If Jerry is 71 and his son is 48, Jerry's life expectancy is 26.5 per Table III — Uniform Lifetime Table, and the joint and survivor expectancy is 36.7, so the maximum period certain would be 26 years.

If the distributions begin after the death of the employee, the period certain cannot exceed the life expectancy of the designated beneficiary using the applicable distribution period.

Example 56. If Jerry, in **Example 55**, dies before he turns $70^1/_2$, Jerry, Jr.'s applicable distribution period will determine the allowable period certain. In this case, it is the Single Life Expectancy amount for a 48-year old, or 36.0 years.

Annuities Purchased from an Insurance Company

Defined benefit plans are not the only source for annuities. An employee might opt to purchase an annuity from an insurance company, using the money that is in his/her plan. In that case, there is also an exception to the non-increasing requirement. It allows a cash refund when the employee dies. The amount of the refund is equal to the excess of the premiums paid over the prior distributions. The employee's beneficiary is allowed to recapture all of the premiums paid.

Accrual of Additional Benefits after the Required Beginning Date

Any additional benefits added after the required beginning date must be accounted for separately.

Realistically, this can produce some administrative delay so there is flexibility in the law. As long as the total amount required is paid by the end of the year following the year the benefit accrues, the plan is in compliance with the law.

If an employee is not fully vested in the plan as of December 31, or the required beginning date in the first year, the unvested portion is not included in the accrual amount. Only when an additional portion of the benefit becomes vested is it included.

An actuarial increase will be required for any employee (other than a 5% owner) who retires after the year in which he/she turns $70^1/_2$. The increase must take into account those years between the age of $70^1/_2$ and the actual date of retirement when the employee was not receiving benefits. If the plan does not allow distributions to be delayed and the amounts paid are sufficient, there is no requirement for an actuarial increase, nor is it required for defined contribution plans, governmental plans, or church plans.

Early Distributions from an Annuity

When an employee starts receiving distributions from an annuity, the payment is irrevocable. Prior to his/her required beginning date, the starting date of the annuity is treated as the required beginning date. Designated beneficiaries will be determined at that time and, if the employee dies before he/she is $70^1/_2$, the remaining portion of the benefits must be distributed over the established period. No adjustments or recalculations are required when the employee turns $70^1/_2$.

Example 57. Skip retires at age 65 from Shawn Company. He chooses to take his retirement in the form of an annuity and names his daughter, Nancy, age 40, as his beneficiary. Skip is treated as beginning his required minimum distribution at age 65 and no changes are required when he turns $70^1/_2$ as long as he meets the minimum distribution incidental benefit rules.

Example 58. Skip, in **Example 57**, dies after the annuity begins but before he turns $70^1/_2$. The distributions will continue to be made according to the annuity contract (single or joint lives and, if applicable, period certain). However, the minimum distribution incidental benefit rules must be met on Nancy's share of the annuity payments.

Example 59. In **Example 58**, Skip's life expectancy is calculated differently because he is under the age of 70 when the annuity begins. His applicable distribution period is 27.4 (the amount for a person age 70) plus five (the difference between his age when the annuity begins and 70), for a total of 32.4.

Example 60. If Skip named his wife, Jacky, as his beneficiary, the same provisions would apply. If Skip dies before turning $70^1/_2$ and Jacky also dies before the required beginning date, her date of death will not be substituted for his. Instead, the annuity distributions will continue as begun under the annuity contract.

INDIVIDUAL RETIREMENT PLANS

The basic rules for distributions under the proposed regulations also apply to IRAs, including the simplified employee pension (SEP) and SIMPLE plans to which employers contribute. Below is a summary of the applicable rules:

- Lifetime payouts are calculated using the new Uniform Table.
- After the death of the IRA owner with a designated beneficiary, the remainder of the account is paid out over the life expectancy of the beneficiary.
- If there is no designated beneficiary, and the IRA owner dies after the required beginning date for distributions, the balance is paid out over his remaining life expectancy.
- If there is no designated beneficiary, and the IRA owner dies before the required beginning date for distributions, the balance must be paid out within five years after the year of his death.
- Annuity payments follow the rules outlined in the “Defined Benefit Plans” section.

Rules that are applicable to IRAs only are listed below:

- Required beginning date is April 1 of the year after the year in which a person turns $70^1/_2$.
- A surviving spouse, who is the sole beneficiary, may make the election to treat the IRA as his/her own.
- An eligible surviving spouse is deemed to have made the election to treat the IRA as his/her own if he/she does not take required distributions or make contributions to the account.
- A “deemed election” cannot be made until the final required minimum distribution for the deceased has been withdrawn.
- The required minimum distribution must be calculated separately for each IRA, but the actual distribution can be taken from any account in which the individual is an owner.
- The trustee, custodian, or issuer of an IRA is required to report the required minimum distribution for each account to the IRA owner and to the IRS.

Separate Calculations for Each Account

Since IRA accounts can include a variety of types of contracts, a separate calculation must be made for each one [Reg. §1.408-8(A-9)]. However, the amounts that must be withdrawn from each account can be totaled and the total amount can be withdrawn from any one or more of the accounts.

For the purposes of this rule, IRAs that an individual holds as an IRA owner can be aggregated only with other IRAs the individual owns. Amounts that are in IRAs the individual holds as a beneficiary of the same decedent can be aggregated with each other, but not with IRAs the individual holds as the IRA owner.

Distributions from I.R.C. §403(b) plans do not satisfy the IRA distribution requirements, nor do distributions from IRAs satisfy the distribution requirements from I.R.C. §403(b) plans. Distributions from Roth IRAs do not satisfy the distribution requirements for regular IRAs or for I.R.C. §403(b) plans.

I.R.C. §501(c)(3) ORGANIZATIONS AND PUBLIC SCHOOLS

A tax deferred annuity plan [I.R.C. §403(b) plan] can only be adopted by certain tax-exempt organizations and public schools. The employees can either have accounts to which employers contribute, and/or they are allowed to contribute through salary reductions. For the most part, these plans are treated in the same manner as IRAs for purposes of distributions. The following are exceptions to that similar treatment:

- The required beginning date is the later of April 1 of the year after employee turns $70^1/_2$ or the year in which the employee actually retires. The 5% owner restriction is not applicable in these circumstances.
- The surviving spouse of an employee does not have the option to treat an I.R.C. §403(b) contract as his/her own.

The distribution rules will be applied to all benefits accruing after December 31, 1986. Records of the balance, as of that date, must be kept separately. However, the earnings as of January 1, 1987, are included in the benefits subject to the new proposed regulations. Required minimum distributions are taken from the post-1986 account, and any amount in excess of the required minimum distribution is paid from the pre-1987 balance. If the issuer does not keep the records separate, the entire account will be subject to the new proposed regulations.

If an employee has more than one I.R.C. §403(b) contract, the required minimum distribution must be separately determined for each one, but the required minimum distribution can be taken from any one. A person who owns both a 403(b) contract and an IRA must figure the required minimum distribution for each; they cannot be substituted for each other. It is also possible to aggregate 403(b) contracts held by a beneficiary of the same decedent.

Example 61. Don, age 72, owns **two** 403(b) contracts, having worked as a teacher and a church counselor during his career. He is the beneficiary of his deceased brother Allan's 403(b) contract and IRA. He is also the beneficiary of his deceased wife's 403(b) contract. Don will need to figure the required minimum distribution for all five accounts. He will be required to take required minimum distributions from Allan's contract, his wife's contract, and Allan's IRA. Additionally, he will be required to take the total of the two required minimum distributions from one or both of his own 403(b) contracts.

Example 62. If Don, in **Example 61**, is the beneficiary of Allan's **three** 403(b) contracts, and his wife's **two** contracts, he could aggregate the accounts by original owner. In this case, he could take one required minimum distribution (the total required from all three accounts) from Allan's contracts and one required minimum distribution (the total required from both accounts) from his wife's.

Rollovers And Transfers

As people change jobs or analyze their financial positions, pension plans and IRAs are frequently repositioned. If the transfer is made from one trustee to another, it is not considered a rollover, and there are no tax consequences. A rollover is a tax-free distribution of cash or other assets from one retirement plan to another. The distribution is made to the IRA owner/employee and must be in the new plan within 60 days to avoid paying tax.

A required minimum distribution is not eligible for a tax-free rollover no matter how it is transferred from one account to another.

Example 63. Sharon is 72 years old. Her required minimum distribution for 2002 is $2,800. Because she is not pleased with the earnings on her IRA account, she has the entire balance transferred from one trustee to another in search of better earnings. While the majority of the transfer is a tax-free distribution, the portion that is her required minimum distribution is taxable and cannot be transferred.

Example 64. Ted is 72 years old. He rolls over $25,000 from one of his IRAs to another on December 28, 2002. He will be required to report his 2002 required minimum distributions from both accounts based upon their balances prior to the distribution. In other words, the rollover does not decrease the required minimum distribution for the original account nor does it increase the required minimum distribution for the second account. If Ted does not take his required minimum distribution in addition to the $25,000 he rolled over, the portion of the $25,000 equal to the required minimum distribution is not eligible for rollover.

Example 65. Ted, in **Example 64**, will base his required minimum distribution for 2003 on the new balance in both of his accounts.

Example 66. If the rollover in **Example 64** was not completed in the same calendar year (a possibility, since it was done in late December), it is deemed to be received in the same year as the distribution.

Excise Taxes Under Reg. §54.4974-2

If an IRA owner/employee fails to withdraw the required amount, an excise tax equal to 50% of the difference between the actual withdrawal and the required minimum distribution is imposed.

Example 67. Ted turned $70^1/_2$ in 2001 and is required to make his first required minimum distribution by April 1, 2002. Since Ted left home in October to travel in his recreational vehicle to the homes of all 25 of his grandchildren, he was still on the road in April and never even thought about his required minimum distribution. The balance in his account on December 31, 2000, was $225,000 and his distribution period is 26.5 years since he was 71 at year end. Ted should have withdrawn $8,491 before April 1 , but he was on the road until November 2002. He withdrew $4,000 from his IRA in February for trip expenses. By the time he got back to his house, there was too much catching up to do and the 2002 year closed without Ted making any further distribution for 2001. His excise tax for 2001 is figured on the difference between his $8,491 required minimum distribution and his actual withdrawal of $4,000 ($4,491), and is 50% of that amount, or $2,246. Ted also owes the 50% excise tax on the 2002 required minimum distribution.

Under the final regulations, there is now a provision for waiving the excise tax. "The tax under I.R.C. §4974(a) may be waived if the payee establishes to the satisfaction of the Commissioner the following:

- *The shortfall described in I.R.C. §4974(a) in the amount distributed in any taxable year was due to reasonable error; and*
- *Reasonable steps are being taken to remedy the shortfall."*

Observation. In prior years, it was difficult for the IRS to discover failures to take a required minimum distribution since the calculation of the required minimum distribution was complex and depended upon a variety of individual decisions. Under the new proposed regulations, the IRS has added the IRA reporting requirements that provide for an annual disclosure of the required minimum distribution for each account. Look for the IRS to pursue this new revenue potential. IRS will be able to cross check the return and the amount reported by the IRA issuer.

The final regulations also have a provision for an automatic waiver of the excise tax.

The tax under I.R.C. §4974 will be automatically waived, unless the Commissioner determines otherwise, if

- *The payee described in I.R.C. §4974(a) is an individual who is the sole beneficiary and whose required minimum distribution amount for a calendar year is determined under the life expectancy rule described in Reg. §1.401(a)(9)-3 A-3 in the case of an employee's or individual's death before the employee's or individual's required beginning date; and*
- *The employee's or individual's entire benefit to which that beneficiary is entitled is distributed by the end of the fifth calendar year following the calendar year that contains the employee's or individual's date of death.*

Example 68. Sandy dies at age 62 on November 15, 2001. Her beneficiary is her 73-year-old brother, Jason. He never began taking distributions, although they would have been figured under the life expectancy rule. Just prior to December 31, 2007, Jason withdrew the entire amount from the IRA.

Since the account was closed before the 5-year period, there will be no excise tax. This exception is only available for a beneficiary, not for the original owner.

Other Issues in Final Regulations

Calculation Simplification

1. For lifetime distributions, the marital status is determined on January 1 of each year. Divorce or death after that date is disregarded until the next year.
2. A change in beneficiary due to the spouse's death is not recognized until the following year.
3. Contributions and distributions made after December 31 of a calendar year are disregarded for purposes of determining the minimum distribution for the following year.
4. An employee's account balance for the valuation calendar year that is also the employee's first distribution calendar year is no longer reduced for a distribution on April 1 to satisfy the minimum distribution requirement for the first distribution calendar year.

PRE-59$^1/_2$ PENALTY- FREE DISTRIBUTIONS — I.R.C. §72(t)

A specific exception to the 10% early distribution tax applies if the plan owner receives substantially equal periodic payments from the plan. The payments must be distributed at least annually over the owner's life expectancy (or over the joint life expectancy of the owner and a beneficiary). It is surprising to learn of the number of practitioners who are unaware of these provisions, and of the benefits derived by the plan owner who is under the age of 59$^1/_2$ and is in need of funds to sustain an earnings shortfall resulting from early retirement, loss of a job, etc.

GENERAL RULES

IRS Notice 89-25 provides guidelines for the application of I.R.C. §72(t). While it would be nice to say that Notice 89-25 provides clear, concise information on the method choices, as well as the computations, the notice is little more than a rough blueprint of the concept of "substantially equal periodic payments." The one significant benefit of the ambiguity of Notice 89-25 is the inference that the IRS may accept a wide range of periodic payments.

Key Points

- The payments must be substantially equal, meaning that from year to year, the payments cannot dramatically change. Two of the methods require fixed payments for the entire period.
- The payment calculations take into account a payout schedule over the entire life of the owner, or over the joint life of the owner and beneficiary (New Tables I and II, IRS Pub. 590).
- The owner may not discontinue the payments or alter the computation method for at least five years. Payments must continue for the greater of five years or until the owner reaches age 59$^1/_2$.
- IRS Notice 89-25 provides three computation methods for the owner to choose from: the minimum distribution method (life expectancy method), the amortization method, or the annuity method.

Note. Splitting IRAs into smaller IRAs provides even more flexibility to these method choices, as specific IRAs can be used for I.R.C. §72(t) calculations, while others are left out of the calculations. Moreover, one computation method can be used for one IRA, and another method used for a different IRA.

METHOD ONE — MINIMUM DISTRIBUTION METHOD

This method is the easiest of the three, but has one downfall. Computation of the annual payout must be made **each** year, for the following year. Each year, the owner determines the retirement account balance as of December 31 of the previous year, and divides that amount by a life expectancy factor determined from either Table I or Table II in IRS Pub. 590 (Appendix A).

> Note. Generally this method results in the smallest annual payout. The only real decisions to be made with this method are the following:
>
> - Single life expectancy or joint life expectancy?
> - Recalculate or term-certain for the life expectancy factors?
>
> Once those two decisions have been made, three things have to be done.
>
> 1. Determine the life expectancy factor from Table I or Table II.
> 2. Determine the account balance as of December 31 of the previous year.
> 3. Calculate the payment by dividing the account balance by the owner's single or joint life expectancy factor.

METHOD TWO — AMORTIZATION METHOD

This method is undoubtedly the most common of the three methods chosen by plan owners. This method fixes a payout schedule that stays constant for the period of the payout schedule, meaning that annual recomputations are not necessary. In addition, this method generally provides a range of payouts that are between the minimum distribution method and the annuity method.

The key difference between this method and Method One is an interest rate must be used, but the selection of that rate is very flexible per IRS guidelines. Keeping in mind the selection of a high interest rate will result in higher payments than the selection of a lower interest rate, the plan owner has tremendous flexibility in tailoring a payout schedule which fits the owner's cash requirements and preserves retirement assets for later use.

The typical range of interest rates are provided by the monthly Applicable Federal Rates (AFRs), with many IRS private letter ruling favoring either the long-term applicable federal rate or 120% of the midterm applicable federal rate. These rates change monthly, but once chosen for the start of the payout schedule, remain fixed for the life of the payouts. The AFRs can be found in various publications, newsletters, organization Web sites, etc. It is recommended that a copy of the AFR schedule be placed in the client file to substantiate any later inquiry by the IRS. It is the author's belief that consistency is more important than accuracy, based on the flexibility provided by the interest rate choice of this method. A payout schedule computed erroneously, but used consistently (for the full period of the payout schedule) is most likely acceptable.

With the amortization method, four things have to be done:

1. Select an interest rate.
2. Determine the owner's life expectancy in the appropriate table (Table I — Single, Table II — Joint Life) as of the owner's/beneficiary's birthday in the year the payments are to begin.
3. Determine the account balance as of December 31 of the year prior to the first distribution. It is interesting to note that the IRS has allowed use of the account balance as of the month prior to the first distribution. In

computations for clients, the author has generally used the account balance at the time the custodian is called, when making the computations for the client.

4. Calculate the payment by amortizing the account balance using the life expectancy and interest rate selected.

METHOD THREE — ANNUITY FACTOR METHOD

Probably the least used method of the three, the annuity method generally provides the largest payout schedule. This can be both good and bad, depending on the cash needs of the owner now and in future retirement years. This method will generally eat into the retirement principal more rapidly than either of the two other methods. This method also requires the choice of an interest rate, with the same reference to the Applicable Federal Rates (AFRs) as found in Method Two. Another difference with this method is that the owner is allowed to use any reasonable life expectancy assumption, without having to refer to a specific table. This provides flexibility if the owner is either in poor health, meaning possible greater payouts, or is in excellent health with long-lived ancestors, meaning a possible smaller payout than the amortization method would otherwise allow. Given all of this, this method is still the least used of the three.

In order to compute the payout schedule using the Annuity Method, four things have to be done:

1. Select an interest rate.
2. Find the annuity factor from the table.
3. Determine the account balance (same account balance date issue as with the amortization method).
4. Divide the account balance by the annuity factor to determine the payout schedule.

> **Note.** Method One **requires** an annual recomputation to determine the following year's payout schedule. Methods Two and Three require only one computation at the onset of the payout schedule, and once made, the payout schedule remains fixed for the greater of five years or until the owner reaches age $59^1/_2$, whichever period of time is greater.

> **Note.** Commercial software is available to assist in making these computations. The following example is calculated using CFS Tax Tools. Practitioners will generally find that the plan custodians would rather have someone else take on the responsibility of making these calculations, presumably from a liability reduction standpoint.

REV. RUL. 2002-36 Table 1
Applicable Federal Rates (AFR) for June 2002

	Period for Compounding			
	Annual	Semiannual	Quarterly	Monthly
Short-Term				
AFR	2.91%	2.89%	2.88%	2.87%
110% AFR	3.21%	3.18%	3.17%	3.16%
120% AFR	3.50%	3.47%	3.46%	3.45%
130% AFR	3.80%	3.76%	3.74%	3.73%
Mid-Term				
AFR	4.74%	4.69%	4.66%	4.64%
110% AFR	5.23%	5.16%	5.13%	5.11%
120% AFR	5.71%	5.63%	5.59%	5.57%
130% AFR	6.19%	6.10%	6.05%	6.02%
150% AFR	7.16%	7.04%	6.98%	6.94%
175% AFR	8.38%	8.21%	8.13%	8.07%
Long-Term				
AFR	5.70%	5.62%	5.58%	5.56%
110% AFR	6.28%	6.18%	6.13%	6.10%
120% AFR	6.85%	6.74%	6.68%	6.65%
130% AFR	7.44%	7.31%	7.24%	7.20%

Example 69. Below are calculations for early withdrawal without the 10% penalty, using the three methods described earlier in this section.

Taxpayer's Name:	John Riehle	Taxpayer's Age:	52
Beneficiary's Name:	Jane Riehle	Beneficiary's Age:	45
Is the beneficiary the spouse?	Yes	IRA Balance:	$100,000 on 12/31/01
First Year:	2002	Interest Rate:	6.0%

Method One: The IRA balance is divided by taxpayer's life expectancy or joint life expectancy from IRS tables (Pub 590, Tables I or II).

Taxpayer's life expectancy:	32.3	Annual distribution:	$3,096
Joint life expectancy:	42.5	Annual distribution:	$2,353

Method Two: The IRA balance is amortized at 5.00% over taxpayer's life expectancy or joint life expectancy from IRS tables (Pub 590, Table I or Table II).

Taxpayer's life expectancy:	32.3	Annual distribution:	$6,877
Joint life expectancy:	42.5	Annual distribution:	$6,380

Method Three: The IRA balance is amortized at 6.00% over taxpayer's life expectancy from an insurance mortality table (UP-1984 from PCAPP, V25, p456). In this method there is no provision for using joint life expectancy.

Taxpayer's life expectancy:	42.5	Annual distribution:	$6,618

FOR FUTURE YEARS

Method One. Distributions after the **first** year follow the method used for calculating the required minimum distribution after age 70½.

- Taxpayer's life expectancy was **not recalculated**.
- Beneficiary's life expectancy was **not recalculated**.

Distribution year:	2003	IRA Balance:	$105,000 on 12/31/02
Taxpayer's current age:	53	Beneficiary's current age:	46
Taxpayer's life expectancy:	31.3	Annual distribution:	$3,355
Joint life expectancy:	41.5	Annual distribution:	$2,530

Method Two or Method Three. Distributions in subsequent years remain the same as those calculated for the **first** year of distribution.

TERMINATION OF PAYMENTS WITHOUT PENALTY

While payments must continue for the greater of five years, or until the plan owner reaches age 59½, there are two exceptions that exist which can result in termination of the payments without penalty. Without these two exceptions, the 10% early distribution penalty will apply to all payments made under I.R.C. §72(t), without regard to the statute of limitations.

The exceptions are:

1. If the owner dies prior to completion of the payout schedule, the beneficiary may discontinue payments, or
2. If the owner becomes disabled, per Social Security criteria, and the owner is not in any violation of the payout schedule, this will result in retroactive application tied to the payout schedule, and subsequent distributions will not be subject to the early distribution tax.

APPENDIX A

New Life Expectancy and Uniform Lifetime Tables For Use in Figuring Required Minimum Distributions.

- **Table I** is for use by beneficiaries.
- **Table II** is for use by owners who have spouses who are more than 10 years younger. To use Table II, locate one spouse's age on the vertical axis and the other spouse's age on the horizontal axis. The number that is at the intersection of the two ages is the joint life and survivor expectancy number for those two ages.
- **Table III** may be used by all taxpayers to compute their required minimum distribution while they are alive. This table **may** be used for **2002** but **must** be used for **2003 and later years**.

  This table does not apply in the case of:

  1. Beneficiaries of a deceased IRA owner, or
  2. The sole beneficiary of the IRA is the participant's spouse who is more than 10 years younger than the participant.

TABLE I
Single Life Expectancy Table

Age	Life Expectancy	Age	Life Expectancy	Life	Life Expectancy	Life	Life Expectancy
0	82.4	29	54.3	58	27.0	87	6.7
1	81.6	30	53.3	59	26.1	88	6.3
2	80.6	31	52.4	60	25.2	89	5.9
3	79.7	32	51.4	61	24.4	90	5.5
4	78.7	33	50.4	62	23.5	91	5.2
5	77.7	34	49.4	63	22.7	92	4.9
6	76.7	35	48.5	64	21.8	93	4.6
7	75.8	36	47.5	65	21.0	94	4.3
8	74.8	37	46.5	66	20.2	95	4.1
9	73.8	38	45.6	67	19.4	96	3.8
10	72.8	39	44.6	68	18.6	97	3.6
11	71.8	40	43.6	69	17.8	98	3.4
12	70.8	41	42.7	70	17.0	99	3.1
13	69.9	42	41.7	71	16.3	100	2.9
14	68.9	43	40.7	72	15.5	101	2.7
15	67.9	44	39.8	73	14.8	102	2.5
16	66.9	45	38.8	74	14.1	103	2.3
17	66.0	46	37.9	75	13.4	104	2.1
18	65.0	47	37.0	76	12.7	105	1.9
19	64.0	48	36.0	77	12.1	106	1.7
20	63.0	49	35.1	78	11.4	107	1.5
21	62.1	50	34.2	79	10.8	108	1.4
22	61.1	51	33.3	80	10.2	109	1.2
23	60.1	52	32.3	81	9.7	110	1.1
24	59.1	53	31.4	82	9.1	111+	1.0
25	58.2	54	30.5	83	8.6		
26	57.2	55	29.6	84	8.1		
27	56.2	56	28.7	85	7.6		
28	55.3	57	27.9	86	7.1		

Table I is for use by beneficiaries.

TABLE II
Joint and Last Survivor Expectancy (Partial *)

AGES	40	41	42	43	44	45	46	47	48	49
40	50.2	49.8	49.3	48.9	48.5	48.1	47.7	47.4	47.1	46.8
41	49.8	49.3	48.8	48.3	47.9	47.5	47.1	46.7	46.4	46.1
42	49.3	48.8	48.3	47.8	47.3	46.9	46.5	46.1	45.8	45.4
43	48.9	48.3	47.8	47.3	46.8	46.3	45.9	45.5	45.1	44.8
44	48.5	47.9	47.3	46.8	46.3	45.8	45.4	44.9	44.5	44.2
45	48.1	47.5	46.9	46.3	45.8	45.3	44.8	44.4	44.0	43.6
46	47.7	47.1	46.5	45.9	45.4	44.8	44.3	43.9	43.4	43.0
47	47.4	46.7	46.1	45.5	44.9	44.4	43.9	43.4	42.9	42.4
48	47.1	46.4	45.8	45.1	44.5	44.0	43.4	42.9	42.4	41.9
49	46.8	46.1	45.4	44.8	44.2	43.6	43.0	42.4	41.9	41.4
50	46.5	45.8	45.1	44.4	43.8	43.2	42.6	42.0	41.5	40.9
51	46.3	45.5	44.8	44.1	43.5	42.8	42.2	41.6	41.0	40.5
52	46.0	45.3	44.6	43.8	43.2	42.5	41.8	41.2	40.6	40.1
53	45.8	45.1	44.3	43.6	42.9	42.2	41.5	40.9	40.3	39.7
54	45.6	44.8	44.1	43.3	42.6	41.9	41.2	40.5	39.9	39.3
55	45.5	44.7	43.9	43.1	42.4	41.6	40.9	40.2	39.6	38.9
56	45.3	44.5	43.7	42.9	42.1	41.4	40.7	40.0	39.3	38.6
57	45.1	44.3	43.5	42.7	41.9	41.2	40.4	39.7	39.0	38.3
58	45.0	44.2	43.3	42.5	41.7	40.9	40.2	39.4	38.7	38.0
59	44.9	44.0	43.2	42.4	41.5	40.7	40.0	39.2	38.5	37.8
60	44.7	43.9	43.0	42.2	41.4	40.6	39.8	39.0	38.2	37.5
61	44.6	43.8	42.9	42.1	41.2	40.4	39.6	38.8	38.0	37.3
62	44.5	43.7	42.8	41.9	41.1	40.3	39.4	38.6	37.8	37.1
63	44.5	43.6	42.7	41.8	41.0	40.1	39.3	38.5	37.7	36.9
64	44.4	43.5	42.6	41.7	40.8	40.0	39.2	38.3	37.5	36.7
65	44.3	43.4	42.5	41.6	40.7	39.9	39.0	38.2	37.4	36.6
66	44.2	43.3	42.4	41.5	40.6	39.8	38.9	38.1	37.2	36.4
67	44.2	43.3	42.3	41.4	40.6	39.7	38.8	38.0	37.1	36.3
68	44.1	43.2	42.3	41.4	40.5	39.6	38.7	37.9	37.0	36.2
69	44.1	43.1	42.2	41.3	40.4	39.5	38.6	37.8	36.9	36.0
70	44.0	43.1	42.2	41.3	40.3	39.4	38.6	37.7	36.8	35.9
71	44.0	43.0	42.1	41.2	40.3	39.4	38.5	37.6	36.7	35.9
72	43.9	43.0	42.1	41.1	40.2	39.3	38.4	37.5	36.6	35.8
73	43.9	43.0	42.0	41.1	40.2	39.3	38.4	37.5	36.6	35.7
74	43.9	42.9	42.0	41.1	40.1	39.2	38.3	37.4	36.5	35.6
75	43.8	42.9	42.0	41.0	40.1	39.2	38.3	37.4	36.5	35.6
76	43.8	42.9	41.9	41.0	40.1	39.1	38.2	37.3	36.4	35.5
77	43.8	42.9	41.9	41.0	40.0	39.1	38.2	37.3	36.4	35.5
78	43.8	42.8	41.9	40.9	40.0	39.1	38.2	37.2	36.3	35.4
79	43.8	42.8	41.9	40.9	40.0	39.1	38.1	37.2	36.3	35.4
80	43.7	42.8	41.8	40.9	40.0	39.0	38.1	37.2	36.3	35.4
81	43.7	42.8	41.8	40.9	39.9	39.0	38.1	37.2	36.2	35.3
82	43.7	42.8	41.8	40.9	39.9	39.0	38.1	37.1	36.2	35.3
83	43.7	42.8	41.8	40.9	39.9	39.0	38.0	37.1	36.2	35.3
84	43.7	42.7	41.8	40.8	39.9	39.0	38.0	37.1	36.2	35.3
85	43.7	42.7	41.8	40.8	39.9	38.9	38.0	37.1	36.2	35.2
86	43.7	42.7	41.8	40.8	39.9	38.9	38.0	37.1	36.1	35.2
87	43.7	42.7	41.8	40.8	39.9	38.9	38.0	37.0	36.1	35.2
88	43.7	42.7	41.8	40.8	39.9	38.9	38.0	37.0	36.1	35.2
89	43.7	42.7	41.7	40.8	39.8	38.9	38.0	37.0	36.1	35.2

*Sample only - not all inclusive

Table II is for use by owners whose spouses are more than 10 years younger.

TABLE III
UNIFORM LIFETIME TABLE

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

APPENDIX B

Plan Type	Qualified Employer	Who MUST be covered	Plan establishment deadline	Employee maximum annual deferral
401(k)	• All taxable businesses • Tax-exempt organiz.	Any employee with 1,000 hours of service for 1 year; age 21 or older; can exclude certain employees	Last day of fiscal year; not later than beginning of employee contributions	Up to $11,000; 50+ catch-up contributions of $1,000 allowed
401(k) with Safe Harbor	• All taxable businesses • Tax-exempt organiz.	Same as 401(k)	First day of plan year	Up to $11,000; 50+ catch-up contributions of $1,000 allowed
403(b)	I.R.C. 503(c)(3) organiz.	If one employee participates, all other employees are allowed to participate if they contribute at least $200, regardless of years of service	Last day of fiscal year; not later than beginning of employee contributions	Up to $11,000; 50+ catch-up contributions of $1,000 allowed
Defined Benefit Pension	• All taxable businesses • Tax-exempt organiz. • Gov't entities	Same as 401(k), except if immediate 100% vesting, 2 years of service may be required	Last day of fiscal year	No pretax contributions allowed
Money Purchase	• All taxable businesses • Tax-exempt organiz. • Gov't entities	Same as 401(k), except if immediate 100% vesting, 2 years of service may be required	Last day of fiscal year	No pretax contributions allowed
Profit-Sharing	• All taxable businesses • Tax-exempt organiz. • Gov't entities	Same as 401(k), except if immediate 100% vesting, 2 years of service may be required	Last day of fiscal year	No pretax contributions allowed
SEP	• All taxable businesses • Tax-exempt organiz. • Gov't entities	Any employee who worked 3 or past 5 yrs; age 21 or older; may exclude employees with less than $450 in wages	Tax filing deadline, plus extensions	No pretax contributions, except grandfathered SAR-SEP; 50+ catch-up contributions of $1000 allowed
SIMPLE IRA	100 employees or less • All taxable businesses • Tax-exempt organiz. • Gov't entities	Any employee earning $5,000 during past 2 years and who is expecting to earn $5000 in current year; can exclude certain employees	Between Jan. 1 and Oct. 1	$7,000; 50+ catch-up contributions of $500 allowed

Plan Type	Employer deductible annual combined contribution maximum	Employer contribution requirement	Maximum total allocation to employee's account	Allocation formulas for contributions
401(k)	25% of total eligible payroll (maximum pay per employee is $200,000); plus amount of elective deferrals contributed	None, unless plan is top-heavy	100% employee pay or $40,000 whichever is less	• Nonintegrated allocation • Integrated with Soc. Sec. • Cross tested
401(k) with Safe Harbor	Same as 401(k)	One of the following: • Basic match formula • Enhanced match formula • Nonelective contribution	Same as 401(k)	Same as 401(k)
403(b)	Tax deduction is not issue for tax exempt organizations	none	Same as 401(k)	Does not apply
Defined Benefit Pension	Limited to amount needed to fund future benefits (maximum pay per employee is $200,000)	Contributions based on predicted payouts	No individual accounts	Does not apply
Money Purchase	25% of total eligible payroll (maximum pay per employee is $200,000)	Described in plan document	Same as 401(k)	Same as 401(k)
Profit-Sharing	Same as Money Purchase	Flexible contributions allowed each year; employer must make substantial and recurring contributions	Same as 401(k)	No pretax contributions allowed
SEP	25% of employee's pay or $40,000, whichever is less	None; unless plan is top-heavy	25% of employee's pay or $40,000, whichever is less	• Nonintegrated allocation • Integrated with Soc. Sec.
SIMPLE IRA	$14,000 ($7,000 deferral plus $7,000 maximum match)	Dollar for dollar match up to 3% pay, or 2% gross pay for all eligible employees who earn $5,000 during the year	$14,000	Does not apply

Plan Type	Vesting	Distributions controlled by	Employee Loans	Plan Advantages
401(k)	According to schedule	Employer, through plan terms	Yes	• Employee deferral of taxes • Flexible contributions • More flexibility with amounts due to increased deferral limits
401(k) with Safe Harbor	Immediate 100% on non-safe harbor contributions	Employer, through plan terms	Yes	• No discrimination testing • Employee deferral of taxes • More flexibility with amounts due to increased deferral limits
403(b)	According to schedule	Employer, through plan terms	Yes, except indiv. established accts	• Employee deferral of taxes • More flexibility with amounts due to increased deferral limits
Defined Benefit Pension	According to schedule	Employer, through plan terms	Yes	• Annual retirement benefit can be as high as 100% of the highest 3-yr average pay, up to $160,000 • Guaranteed annuity payments for life
Money Purchase	According to schedule	Employer, through plan terms	Yes	Contribution level specified
Profit-Sharing	According to schedule	Employer, through plan terms	Yes	Flexible contibutions
SEP	100% immediate vesting	Employee	Not applicable	• Minimal paperwork and expense • Minimal tax filing • Ongoing contributions not required • More flexibility with amounts due to increased deferral limits
SIMPLE IRA	100% immediate vesting	Employee	Not applicable	• Minimal paperwork and expense • Minimal tax filing • Employee deferral of taxes • More flexibility with amounts due to increased deferral limits