April 8, 2001

IRA BENEFICIARIES CAN TAKE ACTION NOW TO REDUCE 2001 PAYOUTS AND THEIR TAX BILLS

When IRS issued revised proposed regs on how to figure required minimum distributions (RMDs), it was clear that IRA owners could rely on them to figure payouts for 2001. However, it wasn't clear whether the revised regs could be relied on to figure 2001 payouts from an inherited IRA. In a new notice, IRS makes it clear that the revised proposed regs can indeed be relied on to figure 2001 minimum payouts from an IRA after its owner dies. As we explain, this means that IRA beneficiaries can take action now to reduce 2001 payouts, thereby lowering their tax bills for 2001, and lengthening the life-span of the IRA shelter.

BACKGROUND

- The revised proposed regs streamline and simplify the method of computing annual distributions required to be made to both the IRA owner during his life and to designated beneficiaries of the IRA after the owner dies. The revised regs, which overhaul the former regs proposed in '87, also change the payout rules that apply if the IRA owner died without designating beneficiaries for the account. The net effect of the revised rules in many instances is a smaller required annual payout from the IRA. And that is good news for those who can afford to take smaller IRA payouts. It means a lower current tax bill (because gross income will be minimized), and a longer-lived tax shelter for the family.

LIFETIME AND POST-DEATH IRA PAYOUTS

- Although the revised rules are proposed to apply for determining RMDs for calendar years after 2001, the preamble to the proposed regs specifically states that “for distributions for the 2001 calendar year, IRA owners are permitted, but not required, to follow these proposed regulations in operation, notwithstanding the terms of the IRA documents.” This means that IRA owners currently receiving lifetime RMDs can direct the IRA trustee or custodian to make a smaller payout under the revised rules, even if the IRA agreement calls for a larger distribution.

  The preamble to the revised proposed regs did not, however, clearly indicate whether post-death payouts made in 2001 from an IRA whose owner had died before 2001 could be calculated under the revised proposed rules rather than the original proposed reliance regs issued in '87. All it said was that “for determining required minimum distributions for calendar year 2001, taxpayers may rely on these proposed regulations or on the 1987 proposed regulations.” Now IRS has cleared up the ambiguity. Notice 1270 (Supplement to Publication 590, Individual Retirement Arrangements (IRAs), makes it clear that the revised proposed regs can be relied on to figure the minimum 2001 payout from an IRA even if the IRA owner died before 2001.

NEW VERSUS OLD RULES ON POST-DEATH PAYOUTS

Under the revised proposed regs, the non-annuity-type payout rules that apply after the death of the IRA owner are as follows:

… If the IRA has a designated beneficiary, the remaining account balance is paid out over the remaining life expectancy of the beneficiary regardless of whether the owner died before or after his required beginning date (generally April 1 following the year in which the IRA owner died).

… If the IRA does not have a designated beneficiary, and the IRA owner dies after his required beginning date, the balance is paid out over the remaining life expectancy of the account owner.

… If the IRA does not have a designated beneficiary, and the account owner dies before his required beginning date, the account balance must be paid out within 5 years after the owner's death.

By contrast, post-death payouts under the '87 proposed regs depended on:

… Whether the IRA owner took lifetime RMDs over his life only or over the joint lives of the owner and designated beneficiary.

… Whether the IRA owner calculated RMDs by using the recalculation method (which looks to the owner's attained age in each distribution year) or the term-certain method (which uses the owner's life expectancy in the first distribution year and reduces this life expectancy by 1 for each passing year).

The revised proposed regs generally result in smaller RMDs and a longer IRA payout period than the original proposed regs. The extent of the difference will depend on the payout method that was used by the IRA owner before his or her death.

WHEN RMDS ARE DRAMATICALLY SMALLER UNDER REVISED REGS

The revised proposed regs result in dramatically smaller RMDs in some situations. Here are two:

Situation 1. The IRA owner designated a nonspouse beneficiary for the account, used the term-certain method to figure payouts and took RMDs over his or her life only.

Illustration: Sue attained age 70-1/2 in June of '90. Beth, her niece, is the designated beneficiary of Sue's IRA and was age 40 in '90. Sue took RMDs over her life expectancy only, used the term-certain method to figure payouts, and died in 2000. Sue's IRA had a $300,000 balance at the end of 2000.

… The former proposed regs call for the remaining account balance to be

distributed over what's left of Sue's life expectancy (single-life table expectancy for IRA owner's attained age in year she reached age 70-1/2, reduced by 1 for each year in which distributions were made to the decedent). This results in a RMD of $69,767 paid to Beth in 2001 ($300,000 ÷ 4.3 years, which is the 15.3 year single life expectancy at age 71, less 11 years in which distributions were paid to Sue).

... Under the revised proposed regs, the remaining IRA balance is distributed over Beth's life expectancy, using her attained age in the year following the year of the IRA owner's death. This results in a RMD of $9,317 paid to Beth in 2001 ($300,000 ÷ 32.2 years, which is the life expectancy for a 51-year old, Beth's attained age in 2001). That's $60,450 less than the payout required under the original proposed regs.

Recommendation: IRA beneficiaries should figure out whether their 2001 payouts would be much smaller under the revised proposed regs than under the former proposed regs. If the answer is "yes" and they want to defer receipt of taxable income from the IRA and keep its tax shelter going for as long a period as possible, they should immediately notify the trustee or custodian of the IRA to pay out for 2001 the minimum required under the revised proposed regs. As a practical matter, it would be best to specify the maximum dollar figure that should be paid from the IRA.

Observations: Deferring receipt of taxable income from the IRA looks like an even better strategy in the current political climate. If President Bush's proposal to cut tax rates over a period of years is adopted, deferred payouts could face a lower tax bill than they'd be hit with right now.

Also, where the IRA owner chose to take RMDs over his life and a beneficiary's life, the revised rules may not produce substantially smaller payouts than the original proposed regs. In these cases, it may not pay to alter the payout schedule produced by the original RMD rules. In other instances, the revised proposed regs produce the same result as the former proposed regs. For example, when an IRA owner designated a beneficiary and calculated RMDs over his life only using the recalculation method, IRS rulings policy had been to allow the balance remaining at the owner's death to be paid out over the beneficiary's life expectancy. The revised proposed regs prescribe essentially the same result.

Situation 2. The revised proposed regs result in dramatically smaller payouts if an IRA owner dies after RMDs begin, but did not designate a beneficiary for the account.

Illustration: Sam named his estate as beneficiary of the IRA (and under the revised and original proposed regs, is treated as not having designated a beneficiary). Sam attained age 70-1/2 in the first half of '90 and because only natural persons can be "designated beneficiaries," he took RMDs over his life only. Sam died in 2000. His IRA had a $200,000 balance on Dec. 31, 2000.

... Under the former proposed regs, if Sam had used the term-certain method to figure his lifetime RMDs, the remaining account balance would be distributed over what's left of his life expectancy for Sam's attained age in year he reached age 70-1/2, reduced by 1 for each year in which distributions were made to him). For 2001, that would result in an minimum IRA payout of $45,612 to those named to inherit Sam's estate ($200,000 ÷ 4.3, which is the 15.3 year single life expectancy at age 71, less 11 years of payouts). And the IRA would have to be completely depleted by the close of 2005.

... Under the new rules, the payout period after Sam's death is determined by his remaining life expectancy. The remaining life expectancy is the life expectancy factor for the age of the IRA owner as of his birthday in the year of death, reduced by 1 for each elapsed year since the year of death). In our example, the minimum IRA payout for 2001 is $25,326 ($200,000 ÷ 7.9, which is the life expectancy of 8.9 years for someone age 81, the IRA owner's birthday in year of death, reduced by 1). The beneficiaries of Sam's estate can continue using the IRA as a tax-sheltered account until the close of 2008, the last distribution year.

Observations: The results would be even worse under the former proposed regs if Sam had taken payouts using the recalculation method. Had he used this method, the entire IRA balance would have to be paid out by the end of 2002.

Also, taxpayers who inherit an IRA but aren't designated beneficiaries of the IRA should choose to be governed by the revised proposed regs for 2001 if (1) the IRA owner didn't designate any beneficiaries, (2) the IRA owner died after RMDs commenced and (3) they want to make the IRA tax shelter last as long as possible. Where an estate is beneficiary of the IRA, its executor should direct the IRA custodian or trustee to change the payout schedule to conform to the revised proposed regs.

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