HITTING THE RESTART BUTTON ON RMD's IN 2010 - HOW TAXPAYERS AND THEIR BENEFICIARIES ARE AFFECTED

The Federal government's reaction to the stock market crash of 2008 featured a number of tax relief measures, including an unprecedented waiver, for 2009 only, of required minimum distributions (RMD's) from qualified plans and IRAs. Now that the waiver has expired, you will want to know how RMD's for 2010 will be affected by the skipped year of pay-outs. This Hot Topic takes a detailed look at the answer, both for taxpayers receiving RMD's from their retirement plan accounts or IRAs, and for taxpayers receiving RMD's from inherited plan accounts or IRAs.

- **Background on RMD's.** Employer-provided defined contribution qualified retirement plans, IRAs and individual retirement annuities are subject to the RMD rules. Generally, RMD's must begin by the required beginning date (RBD), which usually is April 1 of the calendar year following the calendar year in which the individual (employee or IRA owner) reaches age 70 1/2. But for employer-provided qualified retirement plans, the RBD for non-5% company owners is delayed to April 1 of the year following the year in which the individual retires. For IRA's and defined contributions plans, the lifetime RMD for each year generally is determined by dividing the account balance as of the end of the prior year by a distribution period carried in a uniform table in the regulations. Special rules apply to annuity payments from an insurance contract.

  Minimum distributions after the death of the qualified plan participant or IRA owner depend on whether he died before or after his RBD:

  - If he died on or after his RBD, and designated a non-spouse beneficiary for the account, the IRA balance is paid out over the longer of: (1) the remaining life expectancy of the designated beneficiary, using his attained age in the year immediately following the year of the IRA owner's death, or (2) the remaining life expectancy of the IRA owner, using the owner's attained age in the year of his death. In either case, the life expectancy is found in the Single-Life Table.

  - If he dies before his RBD, and designated a non-spouse beneficiary for the account, there are two methods for satisfying the after-death RMD rules: (1) Under the five-year method, the individual's entire account must be distributed no later than December 31 of the calendar year containing the fifth anniversary of his death; (2) Under the life expectancy method, annual RMD's over the beneficiary's life or over a period not extending beyond his life expectancy, must begin no later than December 31 of the calendar year immediately following the calendar year in which the individual died.

  More liberal rules apply if the sole beneficiary of the account is the taxpayer's spouse. For example, the spouse may roll over the decedent's IRA into his or her own IRA, or elect to treat the IRA as the spouse's own IRA.

Failure to take an RMD triggers a 50% excise tax, payable by the qualified plan participant or IRA owner or his beneficiary. The tax is imposed during the tax year that begins with or within the calendar year during which the distribution was required. The tax may be waived if the distribution did not occur because of reasonable error and reasonable steps are taken to remedy the violation.

- **RMD waiver for 2009.** Under the Worker, Retiree, and Employer Recovery Act (WRERA), no RMD was required for calendar year 2009 from IRA's and employer-provided qualified retirement plans which are defined contribution plans. The relief applied both to otherwise-required lifetime distributions to employees and IRA owners and after-death distributions to beneficiaries. The change was made to help taxpayers who would have been forced to sell depressed-in-value stock or mutual fund shares held by their IRA's or retirement plan accounts in order to make RMD's.

- **RMD's back on track for 2010.** Now that the RMD waiver for 2009 is history, here's a review of the types of taxpayers who are affected by restarted RMD's for 2010, and how.

  (1) *Taxpayers who attained age 70 1/2 before 2009*. The RMD for 2010 for these taxpayers is based on IRA or retirement plan account values as of December 31, 2009, and the life expectancy factor in the Uniform Lifetime Table. The skipped year of RMD's doesn't affect the method of calculating RMD's for 2010, although it likely will affect the amount (the account value as of the end of 2009 should be larger because of the skipped payouts, and the partial market recovery).

  (2) *Taxpayers who attained age 70 1/2 in 2009*. A taxpayer's RBD is determined without regard to the 2009 temporary waiver rule for RMD's, for purposes of applying the RMD rules after 2009.

  Illustration 1: IRA owner Anna Baker attained age 70 1/2 in 2009 and thus her RBD is April 1, 2010. Under pre-WRERA law, the first year for which Anna would have had to take an RMD from her IRA was 2009. Under WRERA, no RMD was required for 2009, and, thus, no distribution for 2009 need be made by April 1, 2010. However, because WRERA did not change the RBD for purposes of determining the RMD for calendar years after 2009, Anna's RMD for 2010 must be made no later than the last day of calendar year 2010.

  (3) *Taxpayers who attain age 70 1/2 in 2010*. The one-year RMD waiver has no effect on these taxpayers. Their RMD for the first distribution calendar year (2010) may be postponed until April 1, 2011. However, taking advantage of this three-month grace period does not absolve the taxpayer from making an RMD for 2011 (the second distribution calendar year) on or before December 31, 2011.

  (4) *Beneficiaries using 5-year method*. Under the five-year method, where the IRA or qualified retirement account owner died before his RBD, his entire account must be distributed to designated beneficiaries no later than December 31 of the calendar year containing the fifth anniversary of the owner's death. However, under

WRERA, the 5-year period is determined without regard to 2009. Thus, beneficiaries on a 5-year payout schedule which would have ended with 2009 or a later year were it not for WRERA's RMD waiver, have an extra year to complete pay-outs from the inherited account.

(5) *Beneficiaries using lifetime payout method*. Where beneficiaries had begun taking distributions from an inherited retirement account before 2009 via the lifetime distribution method, the RMD for 2010 is based on account values as of December 31, 2009, applying the life expectancy factor in the Single Life Table. The skipped year of RMD's doesn't affect the method of calculating RMD's for 2010, although it likely will affect the amount (the account value as of the end of 2009 should be larger because of the skipped payouts, and the partial market recovery).

(6) *Extended distribution election period for some beneficiaries*. A retirement account may allow the owner or beneficiary to choose between a 5-year or lifetime payout, and may specify one or the other payout method if the choice isn't timely made. Where the retirement account allows a choice to be made between 5-year and lifetime pay-outs, it must be made by the earlier of:

(a) December 31 of the calendar year in which the distribution would have to start in order to meet the lifetime payout rule (i.e., for non-spouse beneficiaries, by December 31 of the year following the year of the IRA owner's death), or

(b) December 31 of the calendar year that includes the fifth anniversary of the IRA owner's death.

Observation: As a practical matter, the choice must be made no later than December 31 of the year following the year in which the account owner died.

The deadline for making the 5-year or lifetime payout election is extended to December 31, 2010, if the deadline would have occurred in 2009.

Illustration 2: Barbara Yates, a widow, died at age 65 in 2008. The designated beneficiary of her company sponsored defined contribution plan is her daughter, Mary. Barbara's plan allows a designated beneficiary to choose between a five-year or lifetime payout if the account owner dies before required distributions begin. Mary has until December 31, 2010, to elect to receive a lifetime payout from her mother's retirement account (before WRERA, she would have had to make the change no later than December 31, 2009). If she fails to make the election by the end of this year, the balance in her mother's retirement account must be paid out to Mary in full by no later than December 31, 2014.

Similarly, where a participant's spouse is the designated beneficiary, the spouse has until the end of 2010 to make the election if the deadline would have been the end of 2009.

(7) *Extra year for non-spouse beneficiaries making rollovers from inherited qualified plan accounts to elect life expectancy payout*. Under the Pension Protection Act of 2006 (PPA), effective for distributions after 2006, non-spouse beneficiaries of an inherited qualified plan account may make a trustee-to-trustee transfer of part (or all) of the deceased employee's account balance in a qualified plan to an IRA (or individual retirement annuity), if the plan permits. The transfer is treated as an eligible rollover distribution, the receiving IRA is treated as an inherited IRA and the RMD rules apply, namely those rules dealing with a spousal beneficiary.

Observation: Under the WRERA, qualified retirement plans must offer non-spouse beneficiaries the opportunity to roll over an inherited plan account balance to an IRA set up to receive the rollover on the non-spouse beneficiary's behalf, effective for plan years beginning after December 31, 2009. For earlier plan years, plans could, but were not required to, offer non-spouse beneficiaries this rollover option.

Under the "special rule" of Notice 2007-7, if a plan participant died before his RBD, and the 5-year payout rule applies to a benefit under the plan, the non-spouse designated beneficiary making a rollover of the inherited account may determine the RMD using the life expectancy rule in the case of a distribution made before the end of the year following the year of death. After enactment of the rule waiving RMD's for 2009, IRS modified this special rule so that if the employee's death occurred in 2008, the non-spouse designated beneficiary has until the end of 2010 to make the direct rollover and use the life expectancy rule.