



# INVESTMENT COMPANY INSTITUTE

April 24, 2003

W. Thomas Reeder, Esq.  
Associate Benefits Tax Counsel  
Department of the Treasury  
1500 Pennsylvania Avenue, N.W.  
Room 4022-A  
Washington, DC 20220

Re: Separate Accounts Under the Final Required Minimum  
Distribution Regulations

Dear Mr. Reeder:

The Investment Company Institute<sup>1</sup> commends the Treasury Department and the Internal Revenue Service for their comprehensive efforts to simplify the rules governing required minimum distributions under section 401(a)(9) of the Internal Revenue Code. The Institute has long supported simplification of these rules, and, accordingly, wishes to bring to your attention an aspect of the final rules that creates arbitrary distinctions and produces needless complications for beneficiaries of IRA owners who die before their required beginning dates.<sup>2</sup>

The final regulations permit multiple beneficiaries of such a deceased IRA owner's account to be considered separately for RMD purposes under certain circumstances. Q&A-2(a)(2) of section 1.401(a)(9)-8 provides that if a decedent's account is divided into separate accounts and the beneficiaries of each separate account differ from the beneficiaries of the other separate accounts, then each account is viewed separately for purposes of the RMD rules. This rule allows each beneficiary to receive distributions based on his or her own individual life

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<sup>1</sup> The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,912 open-end investment companies ("mutual funds"), 554 closed-end investment companies and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about \$6.254 trillion, accounting for approximately 95% of total industry assets, and 90.2 million individual shareholders.

<sup>2</sup> Similar difficulties will arise in connection with the establishment of separate accounts for multiple beneficiaries of deceased participants under qualified defined contribution plans, but, for ease of discussion, this letter will focus on the implications of the current rule to beneficiaries of deceased IRA owners. We recommend changes to the separate account rules governing both IRAs and qualified defined contribution plans as to such separate accounts.

expectancy<sup>3</sup> rather than based on the shortest life expectancy among all of the beneficiaries,<sup>4</sup> and thus simplifies the RMD calculation.

The final regulations also contain certain timing requirements, however, that create arbitrary distinctions and needless complexity if the accounts are not established by the end of the calendar year in which the decedent died (Year D).<sup>5</sup> If the separate accounts are established in Year D, then they are recognized for purposes of the RMD for the year following the year of death (Year D+1). In contrast, for deaths occurring late in Year D and in other situations in which the separate accounts are not established until Year D+1,<sup>6</sup> each beneficiary's RMD must be calculated for Year D+1 using the life expectancy of the beneficiary with the shortest life expectancy. Only in Year D+2 and subsequent years, therefore, can the separate accounts be recognized for RMD purposes.

Thus, this rule produces different results for similarly situated beneficiaries based on how quickly separate accounts can be established following the IRA owner's death. This arbitrary distinction serves no tax policy purpose and is unnecessarily cumbersome. In order to demonstrate the arbitrary nature of this rule, we have prepared a side-by-side comparison of the treatment of two sets of beneficiaries who are in all respects identical to each other except for the year in which the separate accounts are established.

### Example

The IRA owner dies in Year D, prior to his required beginning date, and has designated three primary beneficiaries (none of whom is the owner's spouse) to share his IRA equally upon his death: Jack (age 50 in Year D); Jill (age 45 in Year D); and Susan (age 40 in Year D). The fair market value of the IRA is \$120,000 on December 31 of Year D, and, for purposes of this example, there is no return on investment in the account in Year D+1.<sup>7</sup> The only difference between the following two scenarios is the year in which the separate accounts are established.

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<sup>3</sup> The beneficiary may also be able to elect to use the five-year rule, which requires only that the beneficiary withdraw all assets by December 31 of the fifth anniversary year following the IRA owner's death, under certain circumstances. Q&A-4 of § 1.401(a)(9)-3 of the regulations.

<sup>4</sup> Under Q&A-7 of § 1.401(a)(9)-5 of the regulations, the general rule in the case of multiple beneficiaries is that the beneficiary with the shortest life expectancy will be the "designated beneficiary" for purposes of determining the applicable distribution period.

<sup>5</sup> As noted below, the final regulations contain some internal inconsistencies with respect to the timing requirements. If the timing requirements described in this letter do not apply in this context, then we request that the Treasury Department and the Internal Revenue Service issue prompt guidance to clarify this issue.

<sup>6</sup> While the most typical reason for establishing the separate accounts in Year D+1 would be a death that occurs late in Year D, even if the death occurs early in the year, difficulties in identifying and locating beneficiaries may delay the establishment of separate accounts until Year D+1.

<sup>7</sup> Any post-death return on investment for the period prior to the establishment of separate accounts would be required to be allocated among the accounts "on a pro rata basis in a reasonable and consistent manner" under Q&A-3 of section 1.401(a)(9)-8.

**The RMD for Year D+1**

The RMD for Year D+1 would be calculated as follows under each Scenario:

**Scenario #1**  
**Separate accounts established in Year D**

	12/31/D FMV	D+1 divisor	D+1 RMD
Jack	\$40,000	33.3	\$1,201.20
Jill	\$40,000	37.9	<b>\$1,055.41</b>
Susan	\$40,000	42.7	<b>\$ 936.77</b>

**Scenario #2**  
**Separate accounts established in Year D+1**

	12/31/D FMV	D+1 divisor	D+1 RMD
Jack	\$40,000	33.3	\$1,201.20
Jill	\$40,000	33.3	<b>\$1,201.20</b>
Susan	\$40,000	33.3	<b>\$1,201.20</b>

In Scenario #2, Jack, Jill and Susan may be disadvantaged in Year D+1 by the use of Jack's life expectancy for the RMD calculation. First, Jack, Jill and Susan might have been able to opt for a deferred payout within five years rather than commencing lifetime distributions immediately if their accounts had been viewed separately.<sup>8</sup> Second, even if they would have begun payments in Year D+1, as shown in the Scenario #1 table, Jill's and Susan's payouts would have been smaller, and would have allowed both to use their entire life expectancies, if only the separate accounts could have been established before the end of Year D.<sup>9</sup>

The current rule also raises complex tax compliance issues in that an individual beneficiary may not necessarily be aware of the other beneficiaries of the deceased owner's IRA, and financial institutions may be constrained by privacy concerns in providing this information. Even if the individual beneficiary is aware of the other beneficiaries, he or she may not know their birthdates and thus might not be able to determine which beneficiary has the shortest life expectancy. These difficulties could be exacerbated if the multiple beneficiaries held their accounts at different financial institutions as a result of asset transfers.

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<sup>8</sup> *But see* footnote 14, *infra*.

<sup>9</sup> The disparity for Susan between Scenarios #1 and #2 in Year D+1 would be greater if the IRA were larger or if Susan were younger. If the account balance were \$1,200,000, Susan would take out over \$2,600 more in Scenario #2 than in Scenario #1. If she were age 30 in Year D rather than 40, even if the account balance remained at \$120,000, she would take out over \$400 more in Scenario #2 than in Scenario #1.

**The RMD for Year D+2**

The RMD for Year D+2 would be calculated as follows under each Scenario:

**Scenario #1**

**Separate accounts established in Year D**

	12/31/D+1 FMV	D+2 divisor	D+2 RMD
Jack	\$38,798.80	32.3	\$1,201.20
Jill	\$38,944.59	36.9	<b>\$1,055.41</b>
Susan	\$39,063.23	41.7	<b>\$ 936.77</b>

**Scenario #2**

**Separate accounts established in Year D+1**

	12/31/D+1 FMV	D+2 divisor	D+2 RMD
Jack	\$38,798.80	32.3	\$1,201.20
Jill	\$38,798.80	36.9	<b>\$1,051.46</b>
Susan	\$38,798.80	41.7	<b>\$ 930.43</b>

Under the current rule, in both scenarios, Jill and Susan would be able to disregard Jack's life expectancy in Year D+2, and calculate their RMDs based upon their own life expectancies.<sup>10</sup> Having taken the Year D+1 RMD using Jack's life expectancy, however, Jill and Susan may not recognize that they can use a different life expectancy for the distributions in Year D+2 and subsequent years. Therefore, they inadvertently may continue to receive distributions based on Jack's shorter life expectancy, and thus may be disadvantaged permanently by taking out more than required over a significant portion of their lifetimes.

Even if they realize that they can shift to their own life expectancies, however, Jill and Susan cannot simply look up the divisors applicable to their ages in Year D+2. Instead, under the regulations, they must "reconstruct" their life expectancies for the Year D+2 calculation by determining the appropriate divisor based on their ages in Year D+1 and reducing it by one year.<sup>11</sup> This adds yet another confusing complication to a calculation that may already be challenging for the average taxpayer.

Although taxpayers often turn to tax advisers, software providers, and others to obtain assistance with complex tax issues, these sources may be of limited utility in this context. Given the amount of information required for the Year D+1 calculation for separate accounts such as those in Scenario #2, such assistance would likely not be available on any sort of automated system because of the complexity of the Year D+1 calculation in this context and the necessity of providing different rules for Year D+2 calculations and beyond. Although such programming might be possible, tax advisers may choose to perform Year D+1 calculations manually, and taxpayers would incur the resulting higher costs unnecessarily. Even if the Year D+1 calculation were done manually, the automated systems would be complicated by the need to include a program for recognizing those accounts that are part of a group of related accounts and excluding them from automated processing. As noted above, the individual beneficiary may not be aware of other beneficiaries or of the other beneficiaries' birthdates.

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<sup>10</sup> Jack, Jill and Susan also may opt to use the five-year rule in Year D+2 under certain circumstances.

<sup>11</sup> See Q&A-5(c) of § 401(a)(9)-5 of the regulations.

**Unique Issues for Spousal Beneficiaries**

The impact of the arbitrary distinctions and complications created by the current rule would be even more striking if one of the beneficiaries in the example was the spouse of the IRA owner. A surviving spouse who is the sole beneficiary of the deceased spouse's IRA generally may choose to treat the decedent's IRA as his or her own,<sup>12</sup> or delay RMDs until the decedent would have reached age 70-1/2.<sup>13</sup> Under the general rule expressed in the first sentence of (a)(2) of Q&A-2, however, a spousal beneficiary in Scenario #2 would not be considered the sole beneficiary until Year D+2. Accordingly, the general rule would appear to require the spouse to take a distribution in Year D+1, thus potentially reducing his or her retirement savings prematurely.

A later example in Q&A-2(a)(2), however, appears to state exactly the opposite rule. According to the example, if the only beneficiary of a separate account established no later than the end of Year D+1 is the spouse (and other beneficiaries are in other separate accounts), then "distribution of the spouse's separate account need not commence until the date determined under the first sentence in Q&A-3(b) of § 1.401(a)(9)-3, even if distribution of the other separate accounts must commence at an earlier date."<sup>14</sup> Thus, the current rule is at least internally inconsistent, and may even deny to certain surviving spouses distribution options that are available to those otherwise similarly situated.

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Given the inequities and complexities detailed above, the Institute urges the Treasury Department and the Internal Revenue Service to allow separate accounts established in Year D+1 to be recognized in Year D+1 for RMD purposes. We also request the opportunity to meet with Treasury and IRS officials to discuss these issues in further detail. Please feel free to contact me at (202) 371-5432 to arrange such a meeting or to request further information.

Sincerely,

  
Kathy D. Ireland  
Senior Associate Counsel

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<sup>12</sup> Q&A-5 of § 1.408-8 of the regulations.

<sup>13</sup> Code § 401(a)(9)(B)(iv).

<sup>14</sup> After the quoted sentence, the final regulations provide another example that seems to indicate that, so long as the separate accounts are established by the end of Year D+1, then one beneficiary can receive distributions over his or her own life expectancy even though distributions from other separate accounts to other beneficiaries are made pursuant to the five-year rule. This example similarly appears to contradict the general timing rule expressed in the first sentence of Q&A-2(a)(2).

W. Thomas Reeder, Esq.

April 24, 2003

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cc: William F. Sweetnam, Jr., Esq.  
Marjorie Hoffman, Esq.  
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