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Techniques for Asset Retention using Required Minimum Distributions

The new Required Minimum Distribution rules issued last April provide fewer taxpayer options, and therefore fewer opportunities to maximize assets, than the 1986 regulations allowed. However, there are still ways to reduce distributions or to time distributions that will maximize asset retention, benefiting both the account holder and the financial product provider. Let's look at three techniques that are broadly applicable.

#1: Timing of the Initial Distribution

The new regulations still provide the option to postpone the initial required minimum distribution until April 1 of the following year. Taking advantage of this option used to be a good idea, but now, in most cases, it no longer makes sense.

Under the old rules, there was no penalty for postponing the first distribution. When it was time for the second distribution, the plan balance was adjusted to reflect the first payment, even if it had not been made by December 31 of the preceding year. The new rules, while simplifying the calculation, took away this adjustment, so that if the first required distribution is not made by December 31, the second required distribution will be based on the actual unreduced December 31 balance, which means a larger distribution will be required in the second year.

The new rules simplify the calculations, but they remove the benefit of postponing the first year's distribution. You are now slightly better off (in most cases) making the first distribution on time!

In most cases, the negative effect of the higher second distribution will more than offset the extra earnings from delaying the first distribution by three months.

Here is a simple example:

Assumptions: $200,000 plan balance
8.00% effective annual yield on funds
April 2002 rules are in use

	Postpone First Distribution until April 1 of 2nd year	Make First Distribution on December 31 of 1st year
Initial balance	**$200,000**	**$200,000**
1st Distribution amount	7,299	7,299
Interest during 1st year	16,000	16,000
December 31 balance (1st year)	**216,000**	**208,701**
Interest during 1st Q of 2nd year	4,196	4,054
April 1 balance (2nd year)	**212,897**	**212,755**
Interest for remainder of 2nd year	12,650	12,642
2nd Distribution amount	8,151	7,876
December 31 balance (2nd year)	**217,396**	**217,521**

The difference is not a great one: only about 6 basis points in this example. But in a flat market, where there would be zero interest in the first quarter of the second year, the difference would be about 15 basis points. Only in a strongly rising market (or in a case where the spouse is more than 10 years younger) do the increased earnings during the first quarter of the second year compensate for the higher second year distribution. The breakeven annualized ROR is 14.36% in most cases. If the funds are expected to earn less than that, it is better to withdraw on December 31.

It is also worth noting that the difference carries forward into future years, and therefore compounds. ***The real point, though, is that whereas it used to be mildly advantageous to advise people to wait until April 1 for the first withdrawal, now, in most cases, it is now mildly counter-productive to do so.***

#2: The Inherited IRA can still make a big difference

The "Inherited" or "Stretch" IRA concept was used under the old rules to obtain a lower required distribution from the very beginning. Under the old rules, even the first distribution could be based on the joint life expectancy of the account holder and a much younger non-spouse beneficiary.

Under the new regulations, the required minimum distribution amount for the living account holder does not depend on the beneficiary's age (unless the spouse is sole beneficiary and is more than 10 years younger). So the Inherited IRA technique doesn't work the way it used to.

Naming children or grandchildren as beneficiaries can still pay off after the account holder dies, but in cases where there is a spouse, and especially if the spouse is younger than the account holder, it can be much better to name the spouse as beneficiary. Then, assuming the account holder dies first, the spouse can roll over or re-characterize the account as her (let's assume a widow in this case) own account, and stop the required distributions until her own age 70½. Then she can name the children or other younger persons as her own beneficiaries, and further extend the plan. Here's a hypothetical case:

Assumptions: $200,000 plan balance
Account holder born November 1930, dies in 2005
Spouse born March 1942, dies 2015
Child born May 1960
8.00% effective annual yield on funds
New rules are in use

Annual Required Distributions from the Account

	No Beneficiary	Spouse Only Beneficiary	Old Inherited IRA: Child Beneficiary	NEW Inherited IRA
2002	$ 7,812	$ 7,407	$ 7,812	$ 7,407
2003	8,429	7,992	8,429	7,992
2004	9,093	8,623	9,093	8,623
2005	9,809	9,302	9,809	9,302
2006	18,774	0	10,679	0
2007	20,407	0	11,574	0
2008	22,197	0	12,547	0
2009	24,162	0	13,604	0
2010	26,325	0	14,753	0
2011	28,715	0	16,004	0
2012	31,372	13,600	17,365	13,600
2013	34,346	14,674	18,848	14,674
2014	37,718	15,832	20,465	15,832
2015	41,623	17,080	22,231	17,080
2016	46,340	31,779	24,160	15,281
2017	52,696	34,520	26,271	16,547
2018	29,139	37,516	28,588	17,921
2019		40,795	31,134	19,410
2020		44,392	33,945	21,026
2021		48,347	37,059	22,779
2022		52,710	40,535	24,681
2023		57,547	44,454	26,747
2024		62,945	48,946	28,990
2025		69,029	54,260	31,427
2026		76,005	61,013	34,075
2027		84,257	62,203	36,955
2028		94,742		40,089
2029		96,592		43,500
2030				47,217
2031				51,270
2032				55,695
2033				60,531
2034				65,826
2035				71,635
2036				78,025
2037				85,077
2038				92,899
2039				101,635
2040				111,496
2041				122,826
2042				136,291
2043				153,608
2044				138,860
TOTAL	**$ 448,957**	**$ 925,685**	**$ 685,781**	**$ 1,846,659**

There are several points of interest in this scenario:

1. In terms of the total monies that will eventually be withdrawn from the fund, the Inherited IRA technique described above is far and away the best alternative. The roughly $1.8 million in eventual withdrawals is just about double the next higher alternative, and almost four times the worst alternative. A similar result, though to a greater or lesser degree, would occur in almost any other scenario where the spouse survives the original account holder.

2. If the spouse dies first, the beneficiary can be changed. So at worst, no harm is done. Keep in mind, however, that this analysis takes into account only the impact of required distributions. In families where estate planning is more complicated, or where the spouse's interests collide with those of the children or grandchildren, other considerations may prevail. But even so, in many (probably most) cases, estate planning considerations would also favor naming the spouse as the original beneficiary.

3. For most families, the old inherited IRA method that involved naming the child or grandchild as beneficiary is no longer the right approach, if there is a suitable spouse beneficiary. ***Any Inherited IRAs that were previously set up with a child beneficiary should be reviewed and, in most cases, changed.***

#3: Active RMD Management

The new regulations impose a new burden on providers – mandatory reporting of Required Minimum Distribution amounts to IRA account holders. But this burden also brings with it a big opportunity.

Perhaps unfortunately, the new reporting requirement allows financial companies to comply while exerting a fairly low level of effort. Companies can use the new Uniform Distribution Table, even if another calculation method would produce a more favorable result. They don't have to (yet) worry about cases in which the original account holder has died, or about 403(b) plans and the grandfathered amounts many of these include. The limited nature of the current requirements lets companies take the easy way out.

But, in this case, the easy way is not the best way. The IRS requirement that companies be in yearly touch with their older IRA clients creates a new opportunity to present a message that will benefit both account holders and financial companies: "Here's the information the IRS now requires that we send you. Our calculations are based on certain information and assumptions, but if you supply us with additional information, or make certain adjustments in your beneficiary designation, we may be able to come up with lower withdrawal requirements. Sometimes these amounts can be substantially lower, which means you can keep your IRA tax shelter working for you as potently and as long as possible."

Are you missing dates of birth for account holders or spouse beneficiaries? With active RMD management you can get them. Are too many account beneficiaries left unnamed, or is an estate or a non-spouse named as beneficiary? This is your chance to encourage clients to re-consider beneficiary designations, perhaps by sending illustrations of the positive impact such changes could have. Would you like to optimize the timing of withdrawals? Now you can advise account holders when to make withdrawals so that their account balances are maximized.

Unfortunately, many companies have administrative software that does not readily enable them to implement active RMD management. That's a shame, because these companies are going to lose millions of dollars – probably tens or hundreds of millions of dollars – in assets under management in coming years. These are assets that, with some extra effort, could be retained.

There is a cost-effective solution. By extracting whatever relevant data is available on current administrative systems, and setting up a database that connects to a Required Minimum Distribution calculator, companies can not only meet the minimum IRS compliance requirements but also actively manage these accounts. Such a database can be infinitely flexible in terms of what additional information is collected and stored, including items that do not fit into a legacy administrative system. The new RMD database will provide additional opportunities to communicate with account holders and to encourage them to provide information and make decisions that will preserve account assets. The assets retained will far more than pay for the cost of setting up and maintaining such a database.

Still River, which specializes in retirement plan calculations, has teamed up with Connect Systems, Inc., which specializes in working with legacy administration systems, to provide companies with this kind of active management program. But situations vary, and some companies may find other approaches better suited to their needs. For example, they could wrap this kind of approach into an existing Client Relationship Management (CRM) system. How a company chooses to proceed doesn't matter; the decision to implement this kind of strategy is what matters.

The cost of <u>not</u> implementing Active RMD Account Management can be staggering!

The payback from active RMD management is hard to quantify. But if you consider that persuading even a single client to switch from an estate beneficiary to an Inherited IRA could quadruple the long-term value of that account, and then think of how many hundreds, thousands, or tens of thousands of such accounts you might have in coming years, the cost of *not* implementing Active RMD Management is staggering.

What do YOU think?

We are very interested in hearing your thoughts on these matters. It will probably be years before all the implications of these new regulations become clear. In the meantime, all of us will learn from one another. We plan to issue an updated version of this analysis in a few months, and would like to include your insights, if you are willing to share them (and be credited for them).

Still River Retirement Planning Software, Inc., provides web-based and desktop software relating to retirement plans and retirement planning. A free demo of our RetirementWorks® system, including our RMD and Inherited IRA illustrations, can be downloaded from our web site: www.StillRiverRetire.com

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