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Required Minimum Distributions, *During Life and After Death*

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I. Introduction

The Required Minimum Distribution rules (“RMD” rules), which were released as Final Regulations by the IRS in April of 2002, dictate when a retirement plan Participant, or the beneficiary of a Participant’s plan, must begin taking money out of the plan and, once distributions have begun, how much must be taken out each year.* These rules, which are among the most complex in the tax code, apply to all employer-sponsored plans (such as pensions, profit sharing plans, and 401(k) plans) as well as IRAs and 403(b) plans. Ironically, these regulations were drafted in response to complaints regarding the complexity of the existing Proposed Regulations, issued on July 27, 1987 as part of the Tax Reform Act of 1986. The good news is that compared to the old set of rules, the RMD rules under the Final Regulations (“the Regulations”) are greatly improved and simplified (although they are still very complex).

The Regulations no longer require Participants to make complicated decisions prior to their Required Beginning Date about their ultimate beneficiary selection or distribution scheme. The Regulations greatly simplify the entire distribution planning process by switching to a single distribution table. This “Uniform Lifetime Table” is used to determine RMDs during life, regardless whether the Participant is married or single, older or younger than a spouse (with one possible exception), or has one, many, or no Designated Beneficiary.

* Treas. Reg. §1.401(a)(9)-0 through -9 (relating to qualified retirement plans); Treas. Reg. §1.408(a)(6) and IRC § 54.4974-2 (specifically relating to IRAs) and Treas. Reg. §1.403(b)-3, A-1(a) (specifically relating to 403(b) plans).

In fact, the Final Regulations allow a Participant to change his or her Designated Beneficiary at any time, and as many times as desired, prior to death. All of these are major improvements. Nonetheless, it is still critical for clients and practitioners to understand how the RMD rules work and how they interact with a Participant's financial and estate planning goals and objectives. This article will examine these issues.

Clients should be aware that the RMD rules outlined in the Regulations represent the minimum distribution amounts under the Internal Revenue Code ("Code"). In some cases, a qualified plan or 403(b) plan may require greater (i.e., faster) distributions than the Code allows. Clients should understand the terms of their particular plan in this respect.

Due to the significant growth of retirement plan assets and due to the importance and complexity of the RMD rules, properly counseling clients on the RMD rules should be a high priority for financial professionals and estate planning specialists alike. In fact, the goal of this article is to discuss the RMD rules in a way that is both functional and easily understandable in order to facilitate the reader's understanding and application of these rules. This article is not designed to be a substitute for a practitioner doing his or her own research with respect to any particular issue regarding a client's Required Minimum Distributions. Books have been written on this subject and there are many issues that are not covered by this article.

II. What The RMD Rules Do And Don't Do Well

The RMD rules are part of a Code structure that allows for the continued tax-deferred growth of qualified retirement plan assets, IRAs and 403(b) plans during the lifetime of the Participant. In fact, if properly arranged, tax-deferral can be maintained for some portion of the retirement plan for the life of the Participant, the life of the Participant's spouse and the life of the spouse's Designated Beneficiary. At the same time, the rules generally require the Participant to take (and pay income tax on) Required Minimum Distributions after a certain age (usually age 70 ½) or, in some cases, after retirement, if later. Different rules apply for spouses, non-spouses, trusts with multiple beneficiaries, charities and estates. Overall, the RMD rules do a respectable job of preventing the perpetual tax-deferral of a Participant's retirement plan assets, as well as making sure that required distributions do not prematurely exhaust the Participant's retirement savings during the joint lives of the Participant and his or her spouse.

Generally speaking, what the RMD rules do not do very well is help Participants preserve and distribute after-tax wealth to the next generation. The older a Participant, the greater his or her annual RMDs and the less available in the retirement account for his or her heirs. So, age alone can prevent the transfer of significant retirement plan wealth to heirs. Also, without proper (and sometimes complex) estate planning, other problems can arise when trying to use the RMD rules to preserve and transfer tax-deferred wealth. Major income and estate tax barriers prevent the ultimate distribution of retirement plan assets intact to heirs. Problems can also arise when there are heirs from multiple marriages, charitable or non-citizen beneficiaries, or when trusts for children (or grandchildren) are named as beneficiaries. This article will discuss many of

these issues. In short, clients need to understand the RMD rules so they can correctly calculate and distribute to themselves each year the required minimum amount and plan for the ultimate transfer of any remaining plan assets to heirs after their death. In addition, clients who intend to preserve assets for distribution to heirs should understand the limits of the RMD system for this purpose.

III. Definitions

The following basic terms are important to understand when advising a client on his or her Required Minimum Distributions.

Participant: For purposes of this article, a Participant is an employee with benefits under an employer-sponsored qualified plan, or a self-employed person with a Traditional IRA or SEP IRA. A Participant could also be a retired person with a Regular IRA or Rollover IRA. If the Participant has a spouse, that spouse will be referred to as the "Participant's Spouse." Note that Roth IRAs do not have RMD requirements during the participant's life. Designated Roth 401(k) accounts are subject to the RMDs during the participant's life.

Designated Beneficiary: A Designated Beneficiary is one or more persons (or qualifying trusts) who are designated by the Participant as a beneficiary of the plan and whose life expectancy is used to distribute the Participant's account balance at death. A Designated Beneficiary must be an individual or a certain type of trust. A Designated Beneficiary cannot be an estate, a charity, or a business entity. Theoretically, however, each of these entities still could be a beneficiary of a plan. A Designated Beneficiary is not officially "designated" until the Designation Date (see definition, below).

Distribution Year: A Distribution Year is any year in which a RMD must be made.

Participant's Age: The Participant's Age is the age attained by the Participant on his or her birthday in the Distribution Year.

Required Beginning Date: The Required Beginning Date ("RBD") is the date that a Participant must begin taking Required Minimum Distributions. The starting point for determining a person's RBD is age 70 ½. For IRAs, the RBD can be extended to April 1st of the calendar year following the year in which the Participant reaches age 70 ½. Roth IRAs have no RBD. Roths do have RMD requirements for non-spouse beneficiaries at the death of the Participant. For a non-5% owner in a qualified plan or for any employee with a 403(b) plan, the RBD is April 1st of the calendar year following the year in which the Participant retires from employment or the year the Participant turns age 70 ½, whichever is later.

Designation Date: After the Participant's death, the Designation Date is the date that the Participant's ultimate choice of Designated Beneficiaries is made final. This date is September 30th of the calendar year following the year of the Participant's death. This date is only one of three post-death deadlines. The deadline for submitting trust documentation to a Plan Administrator in order to allow a trust to be a Designated Beneficiary is October 31st of the calendar year following the year of the Participant's death and the last day to create separate accounts for multiple beneficiaries of an IRA

or qualified plan is December 31st of the year following the year of the Participant's death.

5-Year Rule: When a Participant dies before his or her RBD and has not named a Designated Beneficiary, the Participant's account balance must be distributed by December 31st of the year that contains the fifth anniversary of the Participant's death.

Income In Respect of a Decedent: The term Income in Respect of a Decedent (IRD) refers to the income earned by an individual that is not realized until after death. Death benefits under qualified plans, 403(b) plans and IRAs are considered IRD. At death, IRD is taxed in the estate of a decedent for estate tax purposes and is also taxed to the recipient of the income for income tax purposes. The recipient of the income receives an income tax deduction for any estate tax paid on the IRD by the estate. The income tax deduction is a miscellaneous itemized deduction not subject to the 2% floor.

Uniform Lifetime Table: The Uniform Lifetime Table is the IRS supplied table that is normally used to determine the RMD of a Participant. The factors found in this table are based on the joint life expectancy of the Participant and a hypothetical beneficiary who is ten years younger. The factors begin at age 70 so the first factor (27.4) represents the joint life expectancy of a 70 year old and 60 year old. (See Appendix A) These factors represent the number of years which distributions must be made over life expectancy. Dividing 1 by a factor gives you the percentage of plan assets that must be withdrawn in a given year. The factor 27.4, for example, represents 3.65% (1 / 27.4) of plan assets. Plan assets are valued on December 31st of the prior year. The Participant need not be married nor even name a beneficiary in order to use these factors.¹

Single Life Table: The Single Life Table is the IRS supplied table that is used to determine the RMD of an individual Designated Beneficiary after the death of the Participant. It is used in the same way as the Uniform Lifetime Table. (See Appendix B)²

Joint and Survivor Lifetime Table: The Joint and Survivor Lifetime Table is the IRS supplied table that is used to determine the RMD of a Participant and his or her spouse when the spouse is more than 10 years younger than the Participant. It is used in the same way as the Uniform Lifetime Table.³ For space considerations, this table is not included in this article.

IV. Required Minimum Distributions at the Required Beginning Date

When a Participant reaches his or her Required Beginning Date, Required Minimum Distributions must begin. Once they begin, they must continue each year for the Participant's lifetime. The RMD rules dictate the minimum amount that must be distributed each year. There is no maximum amount. After age 59 ½, a Participant is normally free to withdraw (and pay income tax on) as much of his or her retirement plan assets (plan permitting), IRA, or 403(b) as desired, without penalty. Distributing more

¹ Treas. Reg. §1.401(a)(9)-9, Q&A-2

² Treas. Reg. §1.401(a)(9)-9, Q&A-1

³ Treas. Reg. §1.401(a)(9)-9, Q&A-3

money in one year does not entitle the Participant to distribute less money in another year. Each year's RMD is calculated separately and must be satisfied separately..

Required Minimum Distributions may be made at any time during the Distribution Year, but they must be made by December 31st of the Distribution Year. The first Distribution Year is normally the year in which the Participant attains age 70 ½. However, that date can be extended for IRAs in the first year to April 1st of the following year. For many Participants in employer-sponsored plans and 403(b) plans, the date can be further extended in the first year to April 1st of the year following the year in which the Participant retires, if later. This extension is not available however, for individuals who own more than 5% of the stock of the employer. If a Participant elects to delay distributions in the first year to April 1st of the following year, he or she must take two RMDs in that calendar year. If the Participant has more than one IRA, RMDs may be taken from any one of the IRAs or separately from each IRA.

The best way to show how a RMD is calculated is to use an **example**. Assume the Participant is retired and has a rollover IRA. Assume further that the Participant's date of birth is July 10, 1939. The Participant will be age 70½ on January 10, 2010. Also, assume that the value of the Participant's IRA was \$950,000 on 12/31/08 and \$1,000,000 on 12/31/09. In this example, the Participant's first Distribution Year would be 2010 because that is the year in which he will attain age 70 ½. The RBD for a first Distribution Year of 2010 is April 1st of 2011. The Participant will turn age 71 in his first Distribution Year (he will be age 71 on July 10, 2010), so age 71 will be the age that is used to determine the Participant's Distribution Factor. According to the Table, 26.5 is the factor at age 71. The Distribution Factor is then divided into the value of the IRA as of 12/31/09 (the value of the IRA at the end of the prior year), which was \$1,000,000. The Participant's first RMD is \$37,735.85 ($\$1,000,000 / 26.5$) and this amount may be distributed to him at any time in 2010, but no later than April 1st of 2011.

Now consider RMDs in 2011. At the end of 2010 let's assume that the value of the Participant's IRA will be \$1,050,000. According to the Uniform Lifetime Table, at age 72 the Participant's Distribution Factor is 25.6. This factor is then divided into the value of the IRA as of 12/31/10, which is \$1,050,000. As a result, the Participant's second year RMD is \$41,015.63 ($\$1,050,000 / 25.6$) and that amount may be distributed to him at any time in 2011, but no later than December 31, 2011. If the Participant waits until 2011 to distribute his first RMD, he must take (and pay income tax on) both the first and second distributions in 2011.

If we change the facts slightly and assume that the Participant's date of birth is ten days earlier – on June 30, 1939, the Participant would be age 70 ½ on December 30, 2009. Thus, 2009 (not 2010) would be the Participant's first Distribution Year. So, under the RMD rules, the Participant would have to take his first RMD at any time in 2009, but no later than April 1st of 2010. The Participant would be age 70 in the first Distribution Year (on June 30, 2009), so age 70 would be the age that would be applied to the Uniform Lifetime Table to determine the Participant's first Distribution Factor. According to the Table, 27.4 is the factor at age 70. This factor would then be divided into the value of the IRA as of 12/31/08 (the value of the IRA at the end of the prior year), which was \$950,000. As a result, the Participant's first RMD is \$34,671.53 ($\$950,000 / 27.4$) and

that amount may be withdrawn at any time in 2009 but no later than April 1st of 2010. For the second Distribution Year, assuming the value of the Participant's IRA is \$1,000,000 on 12/31/09, the Distribution Factor would be 26.5 (age 71) and the RMD in the second year would be \$37,735.85 (\$1,000,000 / 26.5). This amount may be withdrawn at any time in 2010, but no later than 12/31/10.

The chart below shows both of the above scenarios through 3 years, and how the RMD calculations can differ simply as a result of a difference of a few days in the Participant's date of birth. When the Participant's birth date is in the first half of the year, the Participant will attain age 70 ½ in that same year and age 70 will be the first age to be used on the Uniform Lifetime Table. On the other hand, when the Participant's date of birth is in the second half of the year, the Participant will attain age 70 ½ in the following year and age 71 will be the first age to be used on the Uniform Table.

Summary of Different Outcomes - Simply Due To The Participant's Birth Date

D.O.B.	IRA Balance	As of 12/31	Dist. Factor	Dist. Year	RMD	Last Day
7/10/39	\$950,000	2008	27.4	N/A	None	N/A
	\$1,000,000	2009	26.5	2010	\$37,735.85	4/1/11
	\$1,050,000	2010	25.6	2011	\$41,015.63	12/31/11
6/30/39	\$950,000	2008	27.4	2009	\$34,671.53	4/1/10
	\$1,000,000	2009	26.5	2010	\$37,735.85	12/31/10
	\$1,050,000	2010	25.6	2011	\$41,015.63	12/31/11

There is more than one way of satisfying the RMD rules. If the Participant does not wish to make these kinds of calculations each year, one option is for the Participant to purchase a life annuity. As long as the annuity payments are based on the life expectancy of the Participant, then the annual payments, by definition, satisfy the Minimum Required Distribution rules. The annuity can have a term certain period to protect heirs in the event of an early death (such as 10-year, 15-year, or 20-year term certain), provided that the term certain does not exceed the term set forth in the Uniform Lifetime Table. For estate planning purposes, at the death of the Participant, the annuity ends and nothing (except the value of any remaining term certain period) is included in the Participant's estate for estate tax purposes. A life annuity is a great way to guarantee a retirement income that cannot be outlived. If the Participant is also concerned about leaving an inheritance to a spouse or children, the Participant might

use other assets to provide this inheritance or purchase life insurance on his own life (possibly held in a trust) for the benefit of these beneficiaries.

V. Distributions to Beneficiaries at the Death of the Participant

When a Participant dies, Required Minimum Distributions for the beneficiary must begin. In order to determine “who receives how much and when” there are five important questions which need to be asked.

Did the Participant die before or after his or her Required Beginning Date?

The rules that determine the period of time over which a non-spouse beneficiary may take RMDs differ depending on whether RMDs have already commenced.

Is the surviving spouse named as sole beneficiary?

A spouse who is named as sole Designated Beneficiary has special distribution and rollover options available to him or her.

Are there multiple beneficiaries named?

The answer to this question is necessary to determine whether separate accounts can and should be created for each beneficiary. Otherwise, RMDs would be determined based on the life expectancy of the oldest beneficiary. This would be the case, for example, if a trust was named as sole beneficiary and there were multiple beneficiaries of the trust.

Is a charity, an estate, or other non-individual named as beneficiary?

A “non-individual” beneficiary such as a charity is not entitled to take RMDs that extend over a life expectancy. Generally, such a beneficiary is limited to the 5-year rule. If a non-individual is named as one of many beneficiaries, it is presumed that no Designated Beneficiary is named and distributions must be made under the 5-year rule.

Has a beneficiary died prior to the Designation Date?

A Designated Beneficiary who dies prior to the Designation Date does not necessarily lose his or her status as Designated Beneficiary. Rather, unless the Designated Beneficiary (or his or her estate) has disclaimed the benefits, RMDs are calculated based on the life expectancy of the deceased Designated Beneficiary (had he or she survived) and are paid to the successor beneficiary.

Many of the above questions can apply to multiple distribution scenarios. As a result, it is often better to discuss the RMD rules “situation by situation” rather than “rule by rule.”

VI. Spouse as Sole Beneficiary - Death Prior To the Required Beginning Date

If a Participant dies prior to his or her Required Beginning Date and names a sole surviving spouse as beneficiary, the spouse has two general options: (1) roll over the plan assets into his or her own Spousal Rollover IRA; or (2) keep the qualified plan or IRA in the name of the Participant. The following explores each of these options:

■ Proceeds Rolled Over to a Spousal IRA

If a Spousal IRA Rollover is elected, the Participant's Spouse would become the Participant. The spouse would no longer be a beneficiary of the deceased's plan but owner of his or her own IRA. The spouse would own a new IRA and all rules regarding IRAs would apply to that IRA.⁴ Therefore, the spouse would be able to defer income tax on all IRA assets (and on all future growth) until attaining age 70½ but, at the same time, the spouse would be subject to a 10% penalty tax on distributions made prior to age 59 ½. At age 70 ½, the spouse would use the Uniform Lifetime Table to calculate his or her RMDs. Most importantly, the spouse would be able to name his or her own beneficiary and thereby permit continuation of the tax deferral for the next generation.

Electing a rollover might create an issue if the original Participant wanted children from his or her prior marriage to receive the remaining IRA proceeds at the spouse's death. The spouse is free to name his or her own beneficiary – such as a new spouse or his or her own children. In order to prevent a Participant's Spouse from rolling over retirement plan assets into a spousal rollover IRA and changing the beneficiary, the Participant might create a QTIP Trust for the spouse.⁵ This would permit the Participant to name his or her children as the remainder beneficiaries of the trust and preserve any remaining retirement plan assets for them. Furthermore, the trust would have to limit the withdrawals of the Participant's Spouse in order to better assure that at least some money remains after the death of the spouse, without violating QTIP rules which require all income be paid to the surviving spouse annually. Sometimes, the only death benefit option available to a Participant of an employer-sponsored qualified plan is a lump sum distribution. If the beneficiary of the Participant's plan is the surviving spouse, then a Spousal IRA Rollover may be the only way to preserve tax-deferral. Depending on the importance of tax-deferral, this may eliminate the QTIP trust option. In discussing RMDs, beneficiary designations, and planning options for retirement plans, remember that the retirement plan must first permit the use of these options before they can be used. Generally, this is not an issue for IRAs.

Without using a trust, the Participant may have problems trying to use the RMD rules to solve real life "distribution" issues such as those involving a second marriage. The classic case, involving children of a former marriage, has income to be paid to a second spouse, remainder to children of the first marriage. This desired distribution might only

⁴ The spousal rollover IRA may in fact be a pre-existing IRA (and funded) of the surviving spouse into which the deceased's account values are transferred. Some surviving spouse's nevertheless prefer to keep separate their original IRA amounts and the new rollover funds.

⁵ IRC § 2056(b)(7)

be accomplished through use of a trust. Many other similar planning scenarios – even involving distributions to children from the same marriage – cannot be achieved using the RMD rules alone.

In some situations, where a charitable objective exists, naming a charitable remainder trust as the beneficiary of the retirement plan or IRA might be more effective in allowing the Participant's family to maintain tax deferral after death and yet achieve the classic distribution pattern (income to spouse for life, remainder to children for life). The downside is that the ultimate remainder beneficiary is the charity – not the grandchildren. The amount passing to charity, however, can be replaced with life insurance, purchased on the life of the Participant or on the lives of the Participant's children, for the ultimate benefit of grandchildren.

■ Proceeds Kept In The Name of the Participant

If a surviving spouse is named as the sole individual beneficiary of the Participant's retirement plan or IRA, and if upon the Participant's death, the Participant's Spouse elects not to immediately rollover the plan to a spousal IRA, then the spouse must begin taking RMDs at the *later of*: (1) the year following the year in which the Participant dies, or (2) the year in which the Participant would have reached age 70 ½.⁶ This rule applies when the Participant dies before his or her Required Beginning Date and a surviving spouse is the sole Designated Beneficiary. The spouse's life expectancy is recalculated annually using the Single Life Table. The following is an **example** of the thought process that might go into deciding whether a spouse should keep an inherited IRA in the name of the Participant.

Aaron was born on July 10, 1952 and his spouse, Rachel was born on March 28, 1957. Aaron names Rachel as the sole individual Designated Beneficiary of his IRA. Aaron dies on May 1, 2010 (age 57). At that time, Rachel decides not to elect a spousal IRA rollover because she is only 53 years old and with a rollover, she would not be able to take penalty free distributions from the IRA until age 59 ½. Instead, Rachel decides to keep the IRA in Aaron's name and remain a beneficiary. By doing so, she must start taking RMDs by the *later of*: 2011 (the year after the year in which Aaron dies) which is Rachel's age 54; or 2023 (the year in which Aaron would have attained age 70 ½) which is Rachel's age 66. Rachel decides to delay taking RMDs until the year 2023. In the meantime, she may take any amount of money that she needs from the retirement plan – penalty free on account of the death of the Participant, which is an exception to the 10% penalty tax on premature retirement distributions.⁷ Between 2010 and 2023, Rachel may always decide to implement a Spousal IRA Rollover.⁸

In the above **example**, Rachel would be under no time deadline to effect a Spousal IRA Rollover, but she still might do so for a number of reasons: (1) to name her own child as

⁶ Treas. Reg. §401(a)(9)(B)(iv)(I)

⁷ IRC § 72(t)(2)(A)(ii)

⁸ IRC § 408(d), Treas. Reg. §1.408-8, A-5(a) and IRC § 402(c)(9)

beneficiary – i.e. avoid dying before having an opportunity to name her own beneficiary, and (2) to use the Uniform Lifetime Table to calculate her RMDs (age 70 factor = 27.4) instead of using the Single Life Table to calculate her RMDs (age 66 factor = 20.2). The age 70 factor is higher and would produce a lower RMD. If Rachel died before rolling over the plan assets to a spousal IRA, the Participant's contingent beneficiary would be able to take future distributions based solely on the spouse's remaining life expectancy. If the Participant's estate were the final beneficiary, then the estate would be stuck with the 5-year rule. In any event, when Rachel starts taking RMDs, she would "recalculate" by going back to the applicable table each year to determine the factor that she needs to divide into the retirement plan or IRA value as of 12/31 of the prior year, to determine her RMD.

VII. Spouse as Sole Beneficiary - Death after the Required Beginning Date

When a Participant dies after his or her Required Beginning Date, a spouse as sole beneficiary may elect a Spousal IRA Rollover. When a spouse does not elect such a rollover, the Internal Revenue Code states that "the remaining portion of such interest will be distributed at least as rapidly as under the method of distributions being used" during the Participant's life.⁹ This is known as the "At Least as Rapidly Rule" which appears to have been administratively overshadowed by the new Regulations. The Regulations state that if a surviving spouse is the sole beneficiary of a retirement plan, then at the death of the Participant (after the RBD) the applicable distribution period is measured by the surviving spouse's life expectancy recalculated each Distribution Year. And after the surviving spouse's death, it is measured by the surviving spouse's life expectancy as of the year of his or death, reduced by one for each calendar year that has elapsed after the spouse's death.¹⁰ Obviously, if the Participant's Spouse were much younger than the Participant, then the above Regulation would not yield a stream of distributions that would be "at least as rapid" as the Participant's RMDs. This is what legal experts refer to when they say that the new Regulations effectively "overrule" a portion of the "At Least as Rapidly Rule".¹¹ At the death of the surviving spouse, the contingent beneficiary of the retirement plan assets or IRA will receive RMDs based on the deceased spouse's life expectancy minus 1 for each succeeding year. Thus, in the example above, if Rachel would have turned age 73 in the calendar year after her death, then using the Single Life Table, the factors used to determine the RMD of a contingent beneficiary would be 14.8 in the first year, 13.8 in the second year, 12.8 in the third year, etc.

VIII. Funding a Q-Tip Trust with Retirement Plan Assets

If a Participant wants to benefit a surviving spouse, obtain the marital deduction and still control the ultimate disposition of the plan assets after the spouse's death, a Qualified

⁹ IRC § 401(a)(9)(B)(i)

¹⁰ Treas. Reg. §1.401(a)(9)-2, A-5 (c)(2)

¹¹ IRC § 401(a)(9)(B)(i)

Terminal Interest Property Trust (QTIP) should be utilized. The QTIP Trust would be named as the beneficiary of the retirement plan, but the plan itself would remain in the name of the Participant. This type of trust is often used in second marriage situations or when the Participant wishes to maintain tax-deferral as well to retain control as to who will receive the remaining account balance after the death of his or her spouse. Naming a QTIP Trust as the beneficiary of a retirement plan, however, has a number of drawbacks.

- (1) Loss of the spouse's ability to rollover plan assets to a Spousal IRA. This will generally reduce the number of years that a family can benefit from income tax deferral as RMDs could start before the spouse is 70 ½.
- (2) Less Wealth Accumulated For Children - Reason #1. Higher RMDs must be paid each year to a QTIP Trust because they are based on the life expectancy of the surviving spouse (using the Single Life Table) not the joint life expectancy of the spouse and a person 10 years younger (using the Uniform Life Table).
- (3) Less Wealth Accumulated For Children – Reason #2. RMDs to a QTIP Trust paid to the younger generation after the spouse's death are based on the spouse's life expectancy as of the date of the spouse's death. If the spouse could rollover the retirement plan to a spousal IRA, then RMDs could be based on the much longer life expectancy of the children.
- (4) QTIP May Not Be Available If Employee Benefits Are Paid As A Lump Sum

As stated earlier, many employer-sponsored retirement plans do not permit any type of death benefit other than a lump sum distribution. Most employers do not want to be responsible for holding a deceased employee's account for such a long period of time (i.e. over the lifetimes of the employee's spouse and children). If Lump Sum is the only distribution option, then the only way for the spouse to preserve tax-deferral will be to elect a Spousal IRA Rollover.

In addition to the above, if the surviving spouse lives too long, the single life factors used to calculate the spouse's RMDs become very large and force the withdrawal of larger and larger amounts. For **example**, at age 85, under the Single Life Table, the scheduled RMD of a surviving spouse who does not elect a Spousal IRA Rollover would be 13.158% of the prior year's account balance. At age 90, the RMD would be 18.182% (factor equals 5.5). Stated another way, at age 90 it is expected that the entire account balance will be distributed in the next 5 ½ years. And if the market value of the IRA at age 90 decreases by a mere 7% in that year, then the remainder beneficiaries of the QTIP trust would have suffered a 25.182% reduction in value in that one year alone. This is especially significant if the remainder beneficiaries of the QTIP trust are not the beneficiaries of the Participant Spouse's estate.

In financial and estate planning, the simple solution is often the best solution. An alternative to using a QTIP Trust to preserve retirement plan assets for children and grandchildren would be to purchase a life insurance policy to fund this legacy and allow the surviving spouse to elect a Spousal IRA Rollover and obtain maximum tax-deferral.

IX. Required Minimum Distributions for a Sole Non-Spouse Beneficiary

Prior to the enactment of the Pension Protection Act of 2006, non-spouse beneficiaries of tax-qualified retirement plans were able to take RMDs over their life expectancy only if the plan permitted it and, for various administrative reasons, many plans did not permit it. Section 829 of the Pension Protection Act has changed this. As of January 1, 2007, a non-spouse beneficiary is now able to fund an Inherited IRA with a Lump Sum Distribution by means of a Trustee-To-Trustee Transfer. The plan must allow Trustee-To-Trustee Transfers, but the IRS has ruled that permission cannot be withheld on a discriminatory basis. Thus, if permission is denied, it must be denied to everyone. This is a major improvement in the law for non-spouse beneficiaries.

If a Participant names a non-spouse individual as the beneficiary of his or her retirement plan or IRA, then that person is the Participant's Designated Beneficiary for purposes of the RMD rules. In order for that person to be entitled to take RMDs over his or her life expectancy, he or she must first be alive on the Designation Date, which is September 30th of the year following the year in which the Participant died. So, if the Participant dies in January of 2010, the Designated Beneficiary must survive more than 20 months (until September 30, 2011) to be eligible to receive RMDs from the Participant's retirement plan. Accordingly, in the first Distribution Year, there are only 3 months after the Designation Date (October, November and December) in which the Designated Beneficiary is able to take his or her first RMD. Also, interestingly, a Designated Beneficiary who dies prior to the Designation Date does not lose his or her status as Designated Beneficiary, unless the benefits have been disclaimed. Rather, RMDs are calculated based on the life expectancy of the deceased Designated Beneficiary (had he or she survived) and are paid to the successor beneficiary. Finally, if no successor beneficiary is named, the estate of the Designated Beneficiary becomes the successor beneficiary – but the estate is not required to use the 5-Year Rule (which is generally reserved for non-individual beneficiaries). The estate would be allowed to take RMDs over the life expectancy of the deceased Designated Beneficiary.

If the Designated Beneficiary survives the Designation Date, he or she may elect one of the following: (1) a Lump Sum Distribution (always an option) (2) the 5-Year Rule (always an option) or (3) RMDs, beginning no later than 12/31 of the year following the year in which the Participant dies. The question is: On whose life should the life expectancy for the RMDs be measured? If the Participant dies before the RBD (Participant's RMDs have not started), the Designated Beneficiary may use only his or her own life expectancy to determine the RMDs. If the Participant dies on or after the RBD (Participant's RMDs have started), the Designated Beneficiary may use either his or her own life expectancy or the Participant's life expectancy (the "At Least as Rapidly" rule is still partly alive). These life expectancies are determined by using the Single Life Table and, after the first year, the life expectancy is reduced by 1 each year to determine subsequent RMDs. The following **example** will help illustrate this concept.

Assume that a Designated Beneficiary is 20 years old and the Participant's RMDs have not started. Then, according to the Single Life Table, the Designated Beneficiary's life expectancy would be 63.0 years. This would be the factor used to determine the first year's RMD. If the value of the Participant's retirement plan were \$1,000,000 on 12/31/10, the Designated Beneficiary's first RMD would be \$15,873.02 ($\$1,000,000 / 63.0$). This represents only 1.587% of the account balance. The retirement plan could grow substantially over the life expectancy of the 20 year-old if in the first Distribution Year the RMD is only 1.587% of the prior year's account balance. After the first year, the Participant's life expectancy is reduced by one (1) for each subsequent Distribution Year. Thus, if the retirement plan or IRA grew by 8% (net of the first year's RMD) to \$1,080,000, the RMD in the second Distribution Year would be \$17,419.35 ($\$1,080,000 / 62.0$), or 1.613% of the account balance.

If the 20 year-old Designated Beneficiary fails to take his or her first RMD on time, then one of two options is available. Option #1: Lump Sum Distribution. Option #2: The 5-Year Rule. Under the 5-Year Rule, the entire account balance would have to be distributed by 12/31 of the year that contains the 5th anniversary of the Participant's death. Obviously, there could be a substantial difference in tax-deferred wealth accumulation between using the "5-Year Rule" and using RMDs over the life expectancy of a 20 year-old. The larger the account balance, the more important it is to follow the rules. Unlike the old Regulations, there is never an instance under the new Regulations where a failure to act forces a lump sum distribution.

It is important to remember that in any given year a Designated Beneficiary can always withdraw more from an IRA or retirement plan (if permitted) than the minimum. To prevent a Designated Beneficiary from withdrawing more than the minimum, (i.e., force a Designated Beneficiary to "save", rather than "spend") a trust for the benefit of the beneficiary with an independent trustee might be established by the Participant and be named beneficiary of the retirement plan or IRA. If the 20 year-old takes only the minimum required distribution and dies before depleting the assets in the plan, the remaining account balance may be distributed, if the plan so permits, to a remainder trust beneficiary based on the Designated Beneficiary's remaining life expectancy.

X. Required Minimum Distributions for Multiple Non-Spouse Beneficiaries

With respect to multiple non-spouse beneficiaries, an employer-sponsored plan may not provide the same flexibility to Participants and Designated Beneficiaries as IRAs. This is especially true with respect to electing distribution options. Although the rules described herein apply to all retirement plans, distributions from employer-sponsored plans are governed by their plan documents and some of the options described in this section may not be available in any one particular employer-sponsored plan. In addition, ERISA rules apply to qualified plans. An IRA beneficiary designation may exclude a surviving spouse. A pension beneficiary designation may not do so, without

the spouse's informed consent. To eliminate confusion, all references made to retirement plans in this section will be referred to as IRAs.

When a Participant names more than one non-spouse IRA beneficiary, the first question is whether all of these beneficiaries are considered individuals under the Regulations.¹² If one or more beneficiaries are not individuals, then the Participant has no Designated Beneficiary and the 5-Year Rule may apply. This may occur, for example, where a corporation, partnership, or charity were named as a co-beneficiary.

If the Participant's beneficiaries are all individuals, then the second question is whether the IRA assets will be held as one account or as separate accounts (one separate account for each beneficiary). Separate accounts may be established for, or by, the beneficiaries, no matter when the Participant has died – prior to, on, or after the RBD. If all beneficiaries are individuals and the IRA is held in one account, then the designated beneficiary with the shortest life expectancy will be the Designated Beneficiary for purposes of determining the applicable distribution period (i.e., RMDs must be taken over the life expectancy of the oldest beneficiary).¹³ Obviously, a beneficiary designation such as “50% to my 80 year old mother and 50% to my 20 year old son” impairs the son's ability to maximize tax deferral. The younger beneficiary must take RMDs based on the older beneficiary's life expectancy. The age of the oldest Designated Beneficiary in the first Distribution Year is calculated in the same way as the age of any Designated Beneficiary; that is, the age on the beneficiary's birthday in the year following the year of the Participant's death. The Single Life Table is used to determine the applicable life expectancy and for each subsequent year. Each year, the prior year's life expectancy is reduced by 1.

If a Participant's IRA is divided into separate accounts and the beneficiaries of each separate account differ from one another, then each account is treated separately for purposes of RMDs.¹⁴ This is an attractive option because it allows individual beneficiaries to take RMDs from their own separate accounts and use their individual life expectancies to determine their RMDs. According to the RMD rules, in order to be effective, separate accounts must be established by 12/31 of the year following the year of the Participant's death.¹⁵ Given the fact that the beneficiary does not even become a Designated Beneficiary until Sept. 30th of that year, this leaves only three months to take action. If the December 31st date is missed, then separate accounts for each Designated Beneficiary can still be established after this date, but RMDs from each of the separate accounts would be based on the life expectancy of the oldest Designated Beneficiary. There are many administrative benefits of creating separate accounts for each beneficiary at any time – especially when the beneficiaries have different investment philosophies or want to withdraw differing amounts in excess of the minimum each year.

¹² Treas. Reg. §1.401(a)(9)-4

¹³ Treas. Reg. §401(a)(9)-5, Q&A-7(a)(1)

¹⁴ Treas. Reg. §1.401(a)(9)-8, Q&A-2(a)

¹⁵ Treas. Reg. §1.401(a)(9)-8, Q&A-2

Sometimes creativity (i.e., post mortem planning) is required to preserve a beneficiary's ability to take RMDs over his or her own life expectancy. Assume a Participant names a charity as beneficiary of 50% of his or her IRA and names two other individual, non-spouse beneficiaries to receive the remaining 50%. Initially, one might conclude that because a charity is a beneficiary there would be no Designated Beneficiary. However, the Designated Beneficiary is not determined until September 30th of the year following the year of the Participant's death. Therefore, if the charity receives its entire interest in the IRA prior to that date, then on Sept. 30th, the two individuals would be the only remaining beneficiaries of the IRA. Therefore, simply distributing its entire interest prior to the Designation Date eliminates the charity as a beneficiary and allows there to be a Designated Beneficiary for purposes of tax-deferral. Furthermore, if the two individuals split the remaining IRA into separate accounts prior to Dec. 31st of the year following the year of the Participant's death, then each would be able to take RMDs over his or her own life expectancy.

Referring to the example where the Participant named his 80 year-old mother and 20 year-old child as IRA beneficiaries, further assume that separate accounts for each beneficiary were established on time and RMDs are being made to each beneficiary using the life expectancy of each beneficiary. What, if anything, changes with regard to RMDs if the 80 year-old mother dies before withdrawing all of the assets from the IRA? Clearly, whoever is entitled to the account must take RMDs calculated in the same way as the deceased Designated Beneficiary had for himself or herself during life. The person would divide the prior year's account balance by the deceased Designated Beneficiary's life expectancy factor using the Single Life Table and then subtract 1 for each subsequent year. The number of years over which distributions must be made is not impacted by the death of the Designated Beneficiary.

The new Regulations are silent as to how a contingent beneficiary is named under these circumstances. The original Participant might have named a contingent beneficiary on a form provided by the IRA Custodian. Alternatively, the Designated Beneficiary could have named a successor in his or her will or living trust or on a form provided by the IRA Custodian. On the other hand, the IRA custodian might require that the remaining balance be paid to the Designated Beneficiary's estate. Due to the IRS's silence, there appears to be no right or wrong answer. Query as to what would happen if two designations were created using different methods and the two designations were in conflict.

XI. Required Minimum Distributions Involving Trusts

Generally speaking, the RMD rules for multiple, individual, non-spouse beneficiaries also apply to qualifying trusts. QTIP trusts, credit shelter trusts and standard irrevocable trusts normally have multiple, individual, non-spouse beneficiaries. The overriding issue when dealing with trusts is whether they are qualifying trusts under the Regulations. If a trust does not qualify, then distributions are limited to the 5-Year Rule. If the trust qualifies, then notwithstanding that a trust is not "an individual," the retirement plan may nevertheless have a Designated Beneficiary. If so, distributions, in general, may be made over the life expectancy of the oldest trust beneficiary.

When the RMD rules are complied with, trust beneficiaries are treated as being Designated Beneficiaries. In a sense, the RMDs will “look past” or “look through” the trust, treating one of the trust’s beneficiaries as the plan’s Designated Beneficiary. In order to comply with the rules, however, the following requirements must be met.¹⁶

1. The trust must be valid under state law as of the Participant’s death.
2. The trust must be irrevocable or will, by its terms, become irrevocable upon the death of the Participant.
3. The beneficiaries of the trust must be identifiable from the trust instrument as of the Participant’s death.
4. The trustee must provide certain documentation to the plan administrator on or before October 31st of the year following the year of the Participant’s death.

Of these four requirements, most of the issues surround requirement #3 – that the beneficiaries be identifiable as of the Participant’s death. For example, what if the trust states that after-born children are included as beneficiaries? Will this disqualify the trust? A related issue is that all trust beneficiaries must be individuals. What if a charity is named as a contingent remainder beneficiary? Will that destroy trust eligibility? The answers are not clear but will be discussed below. Still, it is important to note that if an employer-sponsored plan only offers a lump sum payout to employees and their beneficiaries (and not a life expectancy payout), it makes no difference whether a trust, as beneficiary, qualifies under the RMD rules. The life expectancy payout will not be available. Accordingly, to avoid confusion, retirement plans in this section generally will be referred to as IRAs.

Must All Trust Beneficiaries Be Identifiable?

The Regulation does not require the Designated Beneficiary to be named – just identifiable under the plan instrument.¹⁷ The term “identifiable” includes “members of a class of beneficiaries capable of expansion or contraction...if it is possible to identify the class member with the shortest life expectancy.”¹⁸ The person with the shortest life expectancy would be the oldest person who could ever possibly be named as a beneficiary of the trust. As a result, if the Participant created a trust for the benefit of “all my natural born children and grandchildren” and only one child was living at the time of the Participant’s death, the members of that class would be identifiable because at the Participant’s death there could never be an older child or grandchild born to the Participant. Even though the class of beneficiaries is not closed (i.e. there could be new born grandchildren), no beneficiary with a shorter life expectancy than the current child can ever be added. So, with respect to this issue, the trust would qualify because we know, with certainty, which person has the shortest possible life expectancy among all trust beneficiaries. Beneficiary designations such as the one in this example are common in credit shelter trusts. In fact, typical QTIP language (such as: “to my spouse

¹⁶ Treas. Reg. §1.401(a)(9)-4, Q&A-5

¹⁷ Treas. Reg. §1.401(a)(9)-4, Q&A-5(b)(3)

¹⁸ Treas. Reg. §1.401(a)(9)-4, Q&A-1

for life, remainder to my children) and classic credit shelter trust language (such as: “to my spouse and children as needed, in the discretion of my trustee”) would qualify under the RMD rules. In both cases, the spouse’s life expectancy would be used to calculate RMDs, assuming the spouse had the shortest life expectancy.

Are Separate Accounts Still Needed With A Trust?

If a living trust is named as beneficiary of an IRA, then at the Participant’s death the living trust might typically be divided into several trusts, one for the benefit of each family member. Separate trusts do not constitute separate accounts for purposes of the RMD rules. Separate trusts are not prohibited by the RMD rules, but in order for each beneficiary to take RMDs over his or her individual life expectancy, a separate account for each beneficiary must be created before December 31st of the year following the year of the Participant’s death. The plan benefit is not considered to be in separate accounts merely because it is payable to a trust with multiple beneficiaries.¹⁹

Must All Trust Beneficiaries Be Individuals?

Under the RMD rules, in order to assure that all trust beneficiaries are individuals, the trust remainder beneficiaries must also be identified. This is important even though it is possible for an IRA to be fully distributed before a remainder beneficiary would otherwise be entitled to receive anything under the trust. The trust might still continue if other assets are still owned by the trust. IRA distributions might even be reinvested in the trust. If any of the trust beneficiaries were not individuals, then the trust would likely fail to qualify.

Under the RMD rules, certain successor beneficiaries might be disregarded. For example, if a trust, by its own terms, prohibits the use of IRA benefits to fund particular bequests, the beneficiary of those bequests might be eliminated. Or, if a charity is named as a trust beneficiary but the trust document states that charitable bequests cannot be made from IRA assets, then the charity might be disregarded as a trust beneficiary. Note that this is a conclusion made by experts interpreting the phrase “beneficiaries of a trust with respect to the trust’s interest in an employee’s benefit...”²⁰ This phrase is located in the last sentence of question 11 of Regulation 1.401(a)(9)-8 and has been interpreted to mean that only trust beneficiaries who have an interest in the employee benefit plan (or IRA) need qualify under the RMD rules.²¹ Of course, the corollary of this would be that they also could be eliminated if they do not have such an interest.

Must Successor or Contingent Beneficiaries Be Individuals?

In order for a trust to qualify under the RMD rules (and avoid the 5-Year Rule) all trust beneficiaries must be individuals. Unfortunately, the ability to eliminate certain

¹⁹ PLR 2003-17041, 2003-17043 and PLR 2003-17044

²⁰ Treas. Reg. §1.401(a)(9)-8, A-11

²¹ Cite “*Life and Death Planning for Retirement Benefits*”, Natalie Choate, Copyright 2006

successor or contingent beneficiaries in order to comply with this rule is fraught with peril. According to Regulation 1.401(a)(9)-5, Q&A-7(c):

A person will not be considered a beneficiary for purposes of determining who is the beneficiary with the shortest life expectancy ... or whether a person who is not an individual is a beneficiary, merely because the person could become a successor to the interest of one of the employee's beneficiaries after that beneficiary's death."²²

Yet, in the very next sentence it adds:

"However, the preceding sentence does not apply to a person who has any right (including a contingent right) to an employee's benefit beyond being a mere potential successor to the interest of one of the employee's beneficiaries upon that beneficiary's death."²³

While it is not clear, there may, nevertheless, be sufficient language in this Regulation to suggest that certain remote contingent beneficiaries may be eliminated in determining whether all trust beneficiaries are identifiable and are individuals.

XII. 50% Penalty For Failure To Take RMDs

The IRS imposes a 50% penalty tax for failing to take a RMD.²⁴ This is 50% of the amount that was supposed to be withdrawn. On a case-by-case basis, the IRS may waive the penalty tax if the taxpayer can show that the failure was due to "reasonable error" and that "reasonable steps are being taken to remedy the shortfall."²⁵ Generally speaking, the taxpayer has a choice of paying the penalty and then suing for a refund, or not paying the penalty and incurring interest and penalties while arguing that the penalty was levied in error or should be waived. In order to avoid this issue, the best course of action is to withdraw at least your RMDs annually.

XIII. Taking Distributions Before the Required Beginning Date

Very often, individuals find that they have accumulated substantial amounts in their retirement plans and do not need all of these funds to meet retirement needs. They realize that their financial objectives have changed from "accumulating sufficient funds for retirement" to "preserving wealth for heirs." The first goal is a "retirement planning" goal. The new goal is an "estate planning" goal. How a person views particular assets depends on their perspective. From the perspective of the person who needs to accumulate money for retirement, pre-tax retirement plan assets and IRA funds are

²³ IRC § 4974

²⁴ 4974(d); Treas. Reg. §54.4974-2 Q&A

²⁵ Treas. Reg. §1.401(a)(9)-5, A-7(c)

“high quality dollars”. Generally, they are contributed on a tax-deductible basis and grow income tax-deferred.

From an estate planning perspective, on the other hand, retirement plan assets and IRA funds are “poor quality money”. This is the case simply because at the death of the second to die, these assets are subject to estate tax, generation skipping transfer tax, and income tax. The question is whether it might be advantageous to use some “poor quality money” now (i.e., during life) to create more “high quality money” later (i.e., at death). High quality money might be defined as cash that is free of estate tax, free of generation skipping transfer tax, and free of income tax. Sometimes, high quality money can also be high quantity money, as when life insurance is used to leverage tax-free gifts. In certain instances, life insurance funded by taxable distributions from retirement plans or IRAs may do a better job of creating after-tax wealth for the family than accumulating these funds in a retirement plan and taking only the minimum required distribution each year. Taking IRA distributions early (and paying income taxes early) may not be appropriate for everyone.

Conclusion

Due to the significant growth of retirement plan assets and the importance and complexity of the RMD rules, advising clients on the RMD rules should be a high priority for financial professionals and estate planning specialists alike. The most important decisions clients must make in this area are: (1) how to take distributions in order to achieve a financially secure retirement, (2) how to arrange beneficiary designations in order to benefit family and maximize tax-deferral, and (3) how to coordinate the client’s distribution plan with the client’s overall financial and estate plan. It is the author’s hope that this article will be useful in helping its readers assist their clients in answering these questions.

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Appendix A Uniform Lifetime Table

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

Appendix B: Single Life Table

Age	Life Expectancy	Age	Life Expectancy	Age	Life Expectancy	Age	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		