

The Internal Revenue Service Has Been Busy During 2002

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EXECUTIVE SUMMARY

- This article addresses selected tax developments affecting the construction industry and business owners.

The U.S Treasury and Internal Revenue Service have been busy so far during 2002 (and late 2001) explaining Congress' laws. For the most part the guidance has been taxpayer-friendly.

RETIREMENT PLAN DISTRIBUTION RULES FINALIZED

As reported in the March/April 2001 issue,¹ the U.S. Treasury proposed rules regarding qualified retirement plans distributions. The IRS finalized recently the majority of these proposals.² Most of the rules did not change upon finalization; those that did were, in general, taxpayer friendly.

New Life Expectancy Tables

In general, once an individual is required to receive a retirement plan distribution, the minimum annual amount ("required minimum distribution") is calculated as follows: the retirement plan account balance as of the prior December 31 divided by the individual's life expectancy. The government provides tables listing an individual's appropriate life expectancy. As you can surmise, the longer the life expectancy, the lesser the annual required

payout. The final regulations³ have revised these tables (see Appendices I and II). The revisions have increased the life expectancy at every age. Thus, a taxpayer can receive a smaller annual distribution and have the plan earn more tax-deferred income.

Date by Which to Determine Designated Beneficiary

The final rule scales back the date upon which the plan must designate a beneficiary. The proposed rule allowed for a beneficiary designation through the end of the year following the year of the employee's death. The concern with year end was, if the plan waits until December 31, the administrator still would have to calculate and distribute the required payment by the end of the day. Therefore, to provide sufficient time for the calculations and distribution, the new date to designate a beneficiary is September 30 of the year following the year of the employee's death.⁴

Separate Accounts

To minimize the required annual distributions amongst a plan's multiple beneficiaries, an employee or administrator may create a separate account within the plan for each beneficiary. The final regulations⁵ clarify some of the issues:

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- The plan can have separate accounts for different beneficiaries. These accounts can be established at any time, either before or after the employee is required to receive a minimum distribution.
- The separate accounts are considered when calculating the employee's required minimum distribution only after the later of the year of the employee's death, or the year the separate accounts were established.
- The separate accounts must be established no later than the end of the year following the year of the employee's death to disregard (for purposes of distribution calculations) the beneficiary of any other separate account.

Default Rule For Post-Employee Death Distributions

The rule (1987 proposed regulations) prior to the 2001 proposed regulations was, if an employee died before being required to receive plan distributions and his/her spouse was not the sole beneficiary, the plan funds had to have been distributed to the beneficiary over a five-year period. The 2001 proposals changed the rule to the extent that a nonspouse beneficiary could receive the distributions over his/her life expectancy. Thus, a taxpayer could receive a smaller annual distribution and have the plan earn more tax-deferred income.

The final regulations⁶ provide a transition rule that permits a beneficiary subject to the five-year rule under the 1987 proposed regulations to switch to the life expectancy rule. The one requirement is that all amounts that would have been required to be distributed under the life expectancy rule (had it applied from the start) are distributed by the earlier of December 31, 2003 or the end of the five-year period following the year of the employee's death.

CHANGE TO CASH BASIS METHOD OF ACCOUNTING

As reported in the March/April 2002 issue,⁷ the Internal Revenue Service proposed a revenue procedure⁸ that would permit certain small businesses with average annual gross receipts of \$10 million or less to use the cash basis method of accounting. Construction contractors can qualify under the proposed rules. As an aside, any contractor on the accrual basis method of accounting should strongly consider changing to the alternatives, such as cash or completed contract method.⁹

The IRS recently issued temporary guidance¹⁰ explaining how a taxpayer obtains the former's automatic consent to switch to the cash basis. The IRS indicated that a taxpayer must follow the change in accounting method procedures contained in both Rev. Proc. 2002-9¹¹ and IRS Notice 2001-76. Basically, a taxpayer may change to the cash method¹² for any taxable year ending on or after December 31, 2001 by attaching the original Form 3115, Application for Change in Accounting Method, to its timely filed (including extensions) federal income tax return for that year. For a taxpayer that has filed its 2001 income tax return, the Form 3115 could also be filed on an amended return filed within six months of the original return due date. A duplicate Form 3115 must be filed with the IRS National Office.

CHANGES IN ACCOUNTING METHODS

The Internal Revenue Service issued various guidance to a taxpayer changing its accounting method(s). The IRS has new rules¹³ effective for tax years ending December 31, 2001 by which a taxpayer may obtain the IRS' automatic consent to a change. The revenue procedure specifically addresses long-term contracts¹⁴ as follows:

- This revenue procedure applies only to a taxpayer that enters into a long-term contract on or after January 11, 2001 and must or wants to switch to the per-

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centage of completion method of reporting income. As mentioned in a previous article,¹⁵ the taxpayer must account for such switch on a “cut-off” method—meaning that the contractor would apply the percentage of completion method to a new contract and report any prior contracts under the old method.¹⁶ Thus, there is no Section 481(a) adjustment.

- A contractor needs to refer to Revenue Procedure 97-27¹⁷ if it wants to change to the completed contract method or exempt percentage of completion method (exempt-contract methods).

The IRS modified¹⁸ certain elements of Revenue Procedures 2002-9 and 97-27:

- A taxpayer may change its method of accounting prospectively, without audit protection, if the method is an issue pending under examination, or an issue under consideration by either an appeals office or a federal court; and
- In the case of a change in accounting method that results in a negative Section 481(a) adjustment, the entire adjustment will be reported in the year of change.

The rules¹⁹ for a taxpayer that *involuntarily* changes its accounting method are less favorable than the automatic consent rules. A taxpayer that is contacted for examination and is required by the IRS to change its method of accounting generally receives less favorable terms and conditions. For example, an involuntary change generally is made with an earlier year of change and a shorter positive Section 481(a) adjustment period.

Finally, the following is advice the author received from the IRS National Office. For a contractor to switch from the cash basis to the completed contract method of accounting:

- The first step is to follow the cash to accrual change in accounting method rules. Any positive Section 481(a)

adjustment is spread over four years. Any open job going into the year of change is finished on the accrual basis, not the completed contract method.

- Any new job begun in the year of change is accounted for on the completed contract method.

LONG-TERM CONTRACT

The Internal Revenue Service advised²⁰ that under a contract to build a soil remediation facility and to treat contaminated soil, the latter service did not contribute towards the completion of the facility. Therefore, the income and costs attributable to the soil remediation service had to be accounted for under a nonlong-term contract method.

EMPLOYEE VERSUS INDEPENDENT CONTRACTOR

Another case²¹ was decided in the ongoing debate of classifying a worker as an employee or an independent contractor. The company, a commercial wall and ceiling contractor, hired a carpenter to install drywall. The court held that the carpenter was an independent contractor. The facts the court relied on were, the carpenter:

- had twenty years of experience hanging drywall; the contractor did not have to teach him anything.
- had to supply his own tools.
- did not work in a fixed factory or building.
- retained the ability to work for other contractors.
- was not paid overtime for work in excess of forty hours.
- signed an independent contractor agreement.²²

CERTAIN FRINGE BENEFIT PLANS NO LONGER REQUIRED TO FILE INFORMATION RETURN

The Internal Revenue Service announced²³ that most employers providing their employees fringe benefits through a cafeteria plan,²⁴ educational assistance plan²⁵ or adoption assistance program²⁶ need no longer file Form 5500 Annual Return/Report. The one exception is for an employer that provides a plan covering more than 100 participants. Such an employer needs to continue filing Form 5500. The change applies to all plan years for which information returns have not been filed. For example, a calendar year employer that normally had to file Form 5500 by July 31, 2002 need not file (assuming less than 100 covered employees).

MINIMIZING THE FAILURE TO DEPOSIT PAYROLL TAX PENALTY

The Internal Revenue Service updated its guidance²⁷ with respect to the “failure to deposit tax”²⁸ penalty.²⁹ The guidance assists a taxpayer by giving it an opportunity to minimize the penalty. As a reference point for understanding the current law, here is a brief example of the old law. Assume an employer was required to deposit payroll taxes of \$8,000 on April 17, 2002, \$6,000 on May 1 and \$5,000 on May 15th. The actual deposits for these periods were \$6,000, \$6,000 and \$7,000 respectively. Under the old law, the IRS would apply a deposit first to satisfy the oldest past due deposit liability within the specified tax period. This means that the employer could incur two late payment penalties—one for the first payroll and another for the second payroll. In the above example the IRS would assess a penalty on the April 17th \$2,000 underpayment. The IRS would apply \$2,000 of the May 1st deposit to the April 17th underpayment. Thus, the employer would be deemed \$2,000 underpaid for

the May 1st payroll and liable for another late payment penalty.

Effective for Federal tax deposits required to be made after December 31, 2001,³⁰ the IRS will apply a tax deposit to the most recent tax deposit period and to the most recent tax liability within a specified tax period. For example, an employer may be delinquent with its first and second quarter payroll tax liabilities. Furthermore, the employer is required to deposit taxes monthly. Thus, the employer’s most recent tax liability is for the second quarter (tax deposit period) June payroll (liability within a specified tax period).

The taxpayer can instruct the IRS to apply the deposit to a different tax liability. Such designation may be made within 90 days from the date of IRS’ written penalty notice. The taxpayer would contact the IRS and designate the deposit period to which to apply the deposits of, or credits against, the tax. The taxpayer may either call the toll-free number shown on the penalty notice or write to the Accounts Management Unit at the address shown on the notice.

Applying the new law to the above facts, the IRS would apply the \$6,000 May 1st payment to the same liability. The IRS would satisfy the April 17th shortfall with the \$2,000 May 15th overpayment. Thus, the employer would incur only one late payment penalty (for April 17th). Had the employer wanted to apply a portion of the May 1st payment to the April 17th liability, it would have needed to contact the IRS.

IRS’ APPLICATION OF TAX, PENALTY, AND INTEREST PAYMENTS

The IRS updated and restated³¹ its position as to applying a partial payment of tax, penalty, and interest for one or more taxable periods. This procedure applies to all the Internal Revenue Code taxes but for alcohol, tobacco, firearms, and harbor maintenance taxes. The procedures are as follows:

The Internal Revenue Service updated its guidance with respect to the “failure to deposit tax” penalty.

- The taxpayer may give written instructions as to the application of a partial payment to an assessed tax, penalty, or interest.
- Absent a taxpayer's written instruction, the IRS will apply a payment to a period(s) in the order of priority that the IRS determines will "serve its best interest."
- If a payment applied to a period is less than its total liability, the IRS will apply the payment first to the tax, then to the penalty, and lastly to the interest.

TAX-FREE EXCHANGES WITH UNDIVIDED FRACTIONAL REAL PROPERTY INTERESTS

The Internal Revenue Service commented³² as to when it will issue a ruling that an undivided fractional interest (tenancy in common) in rental real estate is not an interest in a business entity. The relevance of not being a business interest is, the fractional interest could be eligible for a tax-deferred like-kind exchange.³³ For example, Mike and Larry own as tenants in common a rental property. Larry may decide he rather own another building as a sole owner. He would be interested in exchanging tax-free his co-ownership interest in one property for an outright ownership in the other. Had Mike and Larry owned the property in a business entity such as a partnership or S Corporation, Larry clearly could not exchange tax-free his entity ownership interest for a real property interest.³⁴

IRS GUIDANCE ON IMPACT FEES

The Internal Revenue Service ruled³⁵ on whether "impact fees" incurred by a developer upon constructing a residential rental building should be capitalized into building cost, rather than expensing immediately the costs. The impact fees are a one-time charge that the local government imposes on new development

and existing development expansion. The purpose of the fees is to fund specific off-site capital improvements for the general public's use (such as schools, law enforcement, fire protection). The fees are based on the number of rental units in, and the size of, the building.

The IRS ruled that impact fees are incurred by the developer in connection with construction; therefore, the fees are capitalized as indirect costs and allocated to the building. The IRS also provided guidance if a taxpayer wants to change its accounting method to conform to this ruling.

SUBSTANTIATING BY STATISTICAL SAMPLING MEALS AND ENTERTAINMENT EXPENSES

A taxpayer has the burden of proving it has incurred deductible meals and entertainment (M&E) expenditures. Specifically, a taxpayer must substantiate each of the following elements: the amount, the time and place where it was incurred, the business purpose and, in the case of entertainment, the business relationship to the taxpayer of each person entertained.³⁶ The Courts³⁷ have held that for meals and entertainment (versus other classes of business expenses) to be deductible, the taxpayer has to substantiate every element of each expenditure.

Consistent with the above, the IRS National Office ruled³⁸ that a taxpayer could not use a statistical sampling approach to substantiate "fully deductible" meals and entertainment expenditures. In the specific case, the taxpayer determined that many of the expenditures in the M&E account should not have been limited to 50%; rather they were fully deductible meals and entertainment business expenses. Rather than reviewing all the general ledger M&E accounts, the taxpayer reviewed a certain number, created an exception rate, used such rate on all the general ledger M&E accounts, and extrapolated the amount of

fully deductible M&E expenditures. The IRS ruled that it would only allow as fully deductible expenditures those that the taxpayer could individually substantiate; statistical sampling is not a proper methodology.

PARTNERSHIPS, DISREGARDED ENTITIES, AND FEDERAL TAX IDENTIFICATION NUMBERS

As you know, an entity to be treated as a partnership for federal income tax purposes needs to have at least two partners. If ownership is reduced to one, the entity would be treated either as a corporation³⁹ or as a “disregarded entity.” The latter classification means the business activity is reported on the remaining owner’s income tax return; there is no separate business entity for federal income tax purposes. One complexity is, if the owner and/or business maintained a payroll, which federal tax identification number should be used for the surviving payroll.

The IRS issued guidance,⁴⁰ by way of examples, on what happens to an issued federal tax identification number upon changing to, or from, a disregarded entity.

Example 1: Entity X, a partnership, becomes a disregarded entity for federal income tax purposes when X’s ownership is reduced to one partner. X chooses to calculate, report, and pay its employment tax obligations under its own name and tax identification number.

Assuming X chooses to maintain its own payroll, X is required to retain its tax identification number for payroll tax purposes. For all federal income tax purposes other than employment obligations, X must use its owner’s tax identification number.

Example 2: Entity Y is a disregarded entity for federal income tax purposes. Y calculates, reports and pays its employment tax obligations under

its own name and tax identification number. Y becomes a partnership for federal income tax purposes when the entity’s ownership increases to two.

Y must retain its federal tax identification number for use for all federal tax purposes as a partnership.

CHECK-THE-BOX RULES FOR SUBSIDIARY CORPORATIONS

A corporation may be owned by one or more shareholders. If the corporation is owned by at least two shareholders, such shareholders could make an election to treat the entity, for federal income tax purposes, as a partnership. If the corporation is solely-owned by a parent corporation, the parent could elect to treat, for federal income tax purposes, the subsidiary as a division (disregarded entity).

The IRS issued final regulations that provide the following guidance:

- A change from a corporation to a partnership is treated for federal income tax purposes as: the former distributes all of its assets and liabilities to its shareholders in liquidation of the corporation; immediately thereafter, the shareholders contribute all of the distributed assets and liabilities to a newly formed partnership.⁴¹
- A change from a corporation to a disregarded entity is treated for federal income tax purposes as: the former distributes all of its assets and liabilities to its single owner in liquidation of the corporation.⁴² IRC 332 may apply upon the liquidation to mitigate any current income taxation.⁴³

EMPLOYER WITHHOLDING ON STOCK OPTIONS

The IRS extended⁴⁴ the public comment period for its proposal to apply social security taxes, unemployment taxes, and

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income tax withholding to the exercise of incentive stock option plan⁴⁵ and employee stock purchase plan⁴⁶ options. The IRS reiterated that any prior proposals⁴⁷ would not be effective until the IRS issues final regulations. Comments were to be submitted by April 23, 2002. ■

NOTES

¹Glover, *Retirement Plan Distribution Rules Simplified by Proposed Regulations*, Journal of Construction Accounting and Taxation, Volume 11, Number 2.

²Regs. Sec. 1.401(a)(9)-0 through 1.401(a)(9)-9 as reported in the Federal Register Volume 67, No. 74, pp. 18988-19028 (April 17, 2002). The final regulations apply for determining a required minimum distribution for calendar years beginning on or after January 1, 2003. For the calendar year 2002, a taxpayer may rely on either the final regulations, the 2001 proposed regulations, or the 1987 proposed regulations.

³Regs. Sec. 1.401(a)(9)-9, Q-1, Q-2.

⁴Regs. Sec. 1.401(a)(9)-4, Q-4.

⁵Regs. Sec. 1.401(a)(9)-8, Q-2.

⁶Regs. Sec. 1.401(a)(9)-1, Q-2(b)(2).

⁷*Recent IRS Activity*, Journal of Construction Accounting and Taxation, Volume 12, Number 2.

⁸IRS Notice 2001-76, 2001-52 I.R.B. 613 (12/11/01).

⁹This aside assumes the contractor's accounts receivable are growing and exceed the accounts payable.

¹⁰IRS Notice 2002-14, 2002-8 I.R.B. 548 (2/1/02).

¹¹2002-3 I.R.B. 327 (1/8/02).

¹²The second method of accounting associated with this change is to treat inventoriable items as non-incidental materials and supplies, i.e., capitalize the expenditures.

¹³Rev. Proc. 2002-9, 2002-3 I.R.B. 327 (1/8/02), modified and clarified by IRS Announcement 2002-17, 2002-8 I.R.B. 561 (2/4/2002). This procedure clarifies, modifies, amplifies, and supersedes Rev. Proc. 99-49.

¹⁴Appendix Section 7A.

¹⁵Glover, *A Review of 2001 Tax Developments*, Journal of Construction Accounting and Taxation, Volume 12, Number 1.

¹⁶Reg. Sec. 1.460-4(g).

¹⁷1997-1 C.B. 680 (advanced IRS consent rules).

¹⁸Rev. Proc. 2002-19, 2002-13 I.R.B. 696 (3/14/02).

¹⁹Rev. Proc. 2002-18, 2002-13 I.R.B. 678 (3/14/02).

²⁰FSA 200202045 (1/11/02).

²¹Richard Mulzet v. R.L. Reppert, Inc., 88

AFTR2d ¶2001-7203 (E.D. PA, 2001).

²²The agreement provided as follows: As an Independent Contractor, I reserve the right to work for other contractors during and after this agreement has been fulfilled, as long as my work is performed in a timely manner, as per this agreement. If I do not fulfill my duties in a timely manner, Contractor has the right to void this agreement, and deduct any monies paid by Contractor to complete the balance of work in this agreement. I understand I am not an employee and I will not receive any benefits from Contractor. I am aware that I will receive a Form 1099 during January of the year following that which I worked as an Independent Contractor. I am also aware that any taxes due are my sole responsibility, as are liability insurance, worker's compensation insurance, health insurance and any other coverage I deem necessary. It is agreed that Contractor will supply all material for the job and I, as Independent Contractor will supply all transportation, tools, equipment and labor cost under this agreement. I, as an Independent Contractor, will hire, supervise and pay any workers under my direction.

²³IRS Notice 2002-24, 2002-16 I.R.B. 785 (4/4/02).

²⁴IRC 125.

²⁵IRC 127.

²⁶IRC 137.

²⁷Rev. Proc. 2001-58, 2001-50 I.R.B. 579 (12/10/2001).

²⁸This procedure applies to all taxes that are required to be deposited and reported on Form 720 (Quarterly Federal Excise Tax Return), Form 940 (Employer's Annual Federal Unemployment Tax Return), Form 941 (Employer's Quarterly Federal Tax Return), Form 943 (Employer's Annual Tax Return For Agricultural Employees), Form 945 (Annual Return of Withheld Federal Income Tax), Form CT-1 (Employer's Annual Railroad Retirement Tax Return), and Form 1042 (Annual Withholding Tax Return for U.S. Source Income Of Foreign Persons).

²⁹IRC 6656 imposes a penalty when a tax deposit is made after its due date. The penalty is based on the amount of the tax underpayment and the deposit's lateness.

³⁰For tax deposit periods prior to January 1, 2002, guidance for minimizing late deposit penalties was in IRS Notice 98-14, 1998-1 C.B. 585 and Rev. Proc. 99-10, 1999-1 C.B. 272.

³¹Rev. Proc. 2002-26, 2002-15 I.R.B. 746 (4/11/02).

³²Rev. Proc. 2002-22, 2002-14 I.R.B. 733 (3/19/02). The purpose of this revenue procedure is to assist a taxpayer in preparing a ruling request and assist the IRS in issuing advance ruling letters as promptly as practicable. The guidelines are not intended to be substantive rules and are not to be used for audit purposes.

³³The like-kind exchange rules under IRC 1031 enable a taxpayer to trade tax-free a real property interest for another and therefore defer any income tax recognition until the property received in the trade is sold.

³⁴IRC 1031(a)(2).

³⁵Rev. Rul. 2002-9, 2002-10 I.R.B. 614 (2/15/02).

³⁶Regs. Sec. 1.274-5T(b)(2)-(3).

³⁷Dowell v. U.S., 522 F.2d 708, cert. denied, 426 U.S. 920 (1976); Yoon v. Comm'r, 135 F.3d 1007 (5th Cir. 1998).

³⁸FSA 200209028 (3/1/02).

³⁹Regs. Sec. 301.7701-3(c).

⁴⁰Rev. Rul. 2001-61, 2001-50 I.R.B. 573 (12/10/01).

⁴¹Regs. Sec. 301.7701-3(g)(1)(ii).

⁴²Regs. Sec. 301.7701-3(g)(1)(iii).


⁴³Under IRC 332, a corporate parent may avoid recognizing a gain or loss upon the receipt of property from its subsidiary if the latter is completely liquidated. The elective change from a corporation to a partnership or to a disregarded entity is deemed for federal income tax purposes as a complete corporate liquidation.

⁴⁴IRS Announcement 2002-8, 2002-6 I.R.B. 494 (1/25/02).

⁴⁵IRC 422.

⁴⁶IRC 423.

⁴⁷IRS Notice 2001-73, 2001-49 I.R.B. 549 (11/14/2001); IRS Notice 2001-72, 2001-49 I.R.B. 548 (11/14/2001).

Appendices I and II follow. 

Appendix I
Uniform Lifetime Table*

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

*Regs. Sec. 1.401(a)(9), Q-2. Use this table to calculate a required minimum distribution during the employee's lifetime. If the employee's spouse is the *sole* plan beneficiary *and* is more than ten years younger than the employee, this table does not apply; rather, refer to the table listed in Regs. Sec. 1.401(a)(9)-9, Q-3.

Appendix II
Single Life Table*

Age	Divisor	Age	Divisor
35	48.5	73	14.8
36	47.5	74	14.1
37	46.5	75	13.4
38	45.6	76	12.7
39	44.6	77	12.1
40	43.6	78	11.4
41	42.7	79	10.8
42	41.7	80	10.2
43	40.7	81	9.7
44	39.8	82	9.1
45	38.8	83	8.6
46	37.9	84	8.1
47	37.0	85	7.6
48	36.0	86	7.1
49	35.1	87	6.7
50	34.2	88	6.3
51	33.3	89	5.9
52	32.3	90	5.5
53	31.4	91	5.2
54	30.5	92	4.9
55	29.6	93	4.6
56	28.7	94	4.3
57	27.9	95	4.1
58	27.0	96	3.8
59	26.1	97	3.6
60	25.2	98	3.4
61	24.4	99	3.1
62	23.5	100	2.9
63	22.7	101	2.7
64	21.8	102	2.5
65	21.0	103	2.3
66	20.2	104	2.1
67	19.4	105	1.9
68	18.6	106	1.7
69	17.8	107	1.5
70	17.0	108	1.4
71	16.3	109	1.2
72	15.5	110	1.1

*Regs. Sec. 1.401(a)(9), Q-1. Use this table either when: (1) an employee was required to receive annual distributions and does not designate a beneficiary, whereby his/her estate is the beneficiary; or (2) an employee dies prior to being required to receive a distribution and his/her beneficiary is not the spouse.