Understanding RMDs and beneficiary planning

Effective date: January 1, 2003

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INVESTMENT MANAGEMENT

After years of dealing with complex and lengthy proposed regulations, the IRS in 2001 issued new proposed regulations that substantially simplified the rules that govern required minimum distributions (RMDs) and the timing for determining a beneficiary. The IRS accepted comments on these rules throughout 2001 and issued final regulations on April 17, 2002.

These rules were effective January 1, 2003. They will significantly simplify how individuals calculate RMDs and will have a far-reaching impact on estate tax planning.

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Changes in a nutshell

Required minimum distributions (RMDs)

- For calculation purposes, the new IRS Uniform Distribution Table assumes a life expectancy based on the owner's age and an assumed beneficiary who is 10 years younger. It usually doesn't matter if there is a beneficiary on the account or how old the beneficiary actually is. (The only time a different table would be used is when the owner is more than 10 years older than the spouse beneficiary.)
- The complex calculation formulas for the RMD — recalculation, nonrecalculation, or hybrid — are gone. All that is required to calculate the RMD is to divide the year-end value of the retirement account by the factor from the table.

Beneficiary designation

- A designated beneficiary must be determined by September 30 of the year following the year the owner died, which we will refer to as the "gap period."
- In most cases beneficiary changes will no longer have any effect on future RMDs.
- Beneficiaries have more options for taking distributions and for their own estate planning.

RMD calculations — then

Under the 1987 rules, the amount of the RMD was based on the age of the owner and the age of the beneficiary. If the owner was more than 10 years older than the beneficiary, the IRS limited the maximum age difference between the two to 10 years. Once the factor was determined, the owner had to choose from three different calculations. If the owner made a poor choice, the owner was prohibited from changing or correcting it.

Simpler RMD calculations — now

With the introduction of the Uniform Distribution Table (Uniform Table), RMDs become a lot easier to calculate. The table shown here, with its built-in younger beneficiary, means that owners have just one simple calculation to make. Owners who are just beginning RMDs, as well as owners already receiving RMDs, will use the Uniform Table.

The calculation formula

$$\frac{\text{End of year value}}{\text{Uniform Table factor}} = \text{RMD}$$

Beneficiaries have nearly the same tax benefits as owners

RMD key benefits

- The use of a Uniform Table means that owners generally may change beneficiaries after their required beginning date without changing the amount of the RMD. Previously, a beneficiary change could increase the amount of the RMD.
- The new rule may lower the RMD, thus lowering the tax obligation on that distribution.

RMD planning strategies

- Owners can take a larger RMD than what the table provides. The rule determines what the minimum is; owners can always take more than the minimum.
- An owner whose spouse beneficiary is more than 10 years younger may continue to use the joint life expectancy table, which has been updated by the final regulations to reflect the longer life expectancies of people today.

Using the RMD factor

Charles named his wife Betty, age 68, as his beneficiary and began to take his RMD using the recalculation method at age 70½. She passed away; Charles is now age 75. Under the 1987 rules, Charles' new RMD would have been based only on his life expectancy factor of 12.5 years. Under the new rules, his factor is not affected by Betty's death and remains at 22.9 years. The new factor reduces his RMD significantly and thus his current tax obligation.

Uniform Distribution Table

Age of Owner	Distribution Factor
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+	1.9

RMD regulations for beneficiaries — then

A beneficiary who received plan assets under the 1987 rules was significantly limited as to how he or she had to take distributions. Often, the age and calculation method chosen by the owner governed how the beneficiary had to take his or her distributions.

With potential adverse impact on his or her taxes, a beneficiary might have had to

- assume the life expectancy of the owner, or
- take all of the money in one year, or
- take the money within five years

Fairer RMD regulations for beneficiaries — now

When the beneficiary is an individual, rather than a charity, trust, or estate, it is his or her life expectancy that would be used in calculating the RMD. The table illustrates the method for determining the beneficiary's RMD, depending on whether the owner died before or after age 70½, which is the owner's required beginning date. The single life expectancy factor for the beneficiary would be taken from the IRS single life expectancy table, which was also updated by the 2002 final regulations. See IRS Publication 590 for further details.

How to determine a beneficiary's RMD

Beneficiary	Owner dies before required beginning date	Owner dies after required beginning date
Spouse-inherited IRA	Single life expectancy	Single life expectancy
Spouse transfer to own IRA Rollover	Yes	Yes
Child	Single life expectancy*	Single life expectancy*
Child by disclaimer	Single life expectancy*	Single life expectancy*
Grandchild	Single life expectancy*	Single life expectancy*
Grandchild by disclaimer	Single life expectancy*	Single life expectancy*
Two children	Single life expectancy if the account is segregated	Single life expectancy if the account is segregated
Designated Beneficiary Trust	Life expectancy of oldest beneficiary unless separate accounts established	Life expectancy of oldest beneficiary unless separate accounts established
Nondesignated Beneficiary Trust	Five-year rule	Remaining life expectancy of owner*
Charity	Five-year rule	Remaining life expectancy of owner*
Estate	Five-year rule	Remaining life expectancy of owner*

*Factor will be reduced by one each year.

Beneficiary designation rules — then

Previously, an owner had to name a beneficiary before he or she began to take RMDs. That meant that the beneficiary had to be in place before the owner turned age 70½. If the owner didn't have a beneficiary by the required beginning date, then distributions were based on only a single life expectancy. Once RMDs began, owners could change a beneficiary but couldn't change the calculation method. Mistakes in designating beneficiaries were common and difficult or impossible to fix.

More flexible beneficiary designation rules — now

The beneficiary rule changes are the most dramatic of the final IRS regulations. A beneficiary may be determined up until September 30 of the year that follows the year in which the owner died. Beneficiaries who elect to cash out or disclaim assets in the gap period will have no effect on the RMDs of the remaining beneficiaries. In addition, an owner may name a beneficiary at any point during his or her lifetime.

It is the use of the Uniform Table, with its built-in beneficiary assumptions, that frees owners from many of the headaches often associated with retirement, tax, and estate planning. With the changes in the beneficiary rules, owners have more flexibility to name or change a beneficiary after they turn age 70½, their required beginning date. The rules also make it much more effective for beneficiaries to use disclaimers for estate planning.

Beneficiary designation examples

Post 70½ designation

Harriet, a widow with no beneficiary, begins to take distributions at 70½ years old. From the Uniform Table, her life expectancy factor is 27.4 years. At 75, she marries Claude, a spry 67-year-old, and names him as her beneficiary and his sons Harold and Claude, Jr. as contingent beneficiaries. The factor for her distributions is 22.9 years, with or without Claude.

Beneficiary disclaimer: Harriet passes away in 2012 with assets still left in the plan. Claude disclaims his share of the assets. Harold, a wealthy man, also disclaims his share of the assets. As a result, Claude, Jr. receives all of the remaining assets and his RMDs are based on his single life expectancy.

Naming multiple beneficiaries

Charles passes away in 2002 having named his sons John, age 63, and Jim, age 55, as beneficiaries. John will receive 60% of the assets, and Jim will receive 40%. John and Jim have until September 30, 2003, to split the account 60%/40% and until December 31, 2003 to begin taking distributions. If the split is not made, then distributions will be made over the life of the oldest beneficiary, John.

Owners may change the beneficiary designation at any time.

Beneficiary asset distributions — then

A great deal of care had to be taken to structure one's retirement assets so that beneficiaries could extend the distribution period as long as possible. If investors structured their assets poorly, the rules might require that all assets be distributed in the year following the owner's death or that multiple beneficiaries would have to use the life expectancy of the oldest one. Even if the oldest beneficiary disclaimed his or her share of the assets, RMDs for the other beneficiaries would still be based on the disclaiming beneficiary's life expectancy.

More beneficiary control over asset distributions — now

Postmortem determination of beneficiaries makes it possible to avoid many pitfalls and to structure retirement assets more effectively. As a result, beneficiaries are given more control over distributed assets and are better able to stretch distributions over a longer period.

Multiple beneficiaries

There can be multiple beneficiaries named to one IRA. Upon the owner's death, the IRA can be split into separate accounts for each of the beneficiaries. As a result, the beneficiaries can use their own life expectancy factors rather than that of the oldest beneficiary.

Allowing assets to pass to a contingent beneficiary

A primary beneficiary may decide that instead of accepting the assets, he or she would disclaim those assets so that they may pass to other primary beneficiaries, or, if there aren't any, to a contingent beneficiary, such as a child or grandchild. (The beneficiary would have to follow state and federal disclaiming rules.) This provision gives beneficiaries more favorable distribution options and broader estate-planning opportunities.

Beneficiaries have more favorable RMD options and broader estate planning opportunities.

Key beneficiary benefits

1. A beneficiary may be changed at any time, even after distributions to the owner have begun.
2. The beneficiary has no impact on the RMD for the owner, unless the beneficiary is the spouse and is more than 10 years younger than the owner.
3. Disclaimers can now be an effective estate planning strategy.
4. RMDs for individual beneficiaries are now governed by each beneficiary's own single life expectancy.

Beneficiary planning strategies

1. Every owner who is currently taking RMDs should consult a tax adviser and revisit his or her designation of beneficiary and specify a contingent beneficiary.
2. Owners taking RMDs should consult with a tax adviser or investment professional to determine the impact of these new rules.
3. Every retirement plan owner should review all of the beneficiary designations on his or her retirement accounts.
4. Every plan owner should consult with his or her beneficiaries and contingent beneficiaries to make certain that all of them are aware of the new rules, understand them, and know what to do in the event of the owner's death.
5. Owners contemplating a stretch IRA or using the stretch strategy will find that the new rules work very much in their favor.

Every plan owner should review all beneficiary and contingent beneficiary designations.

Questions and answers

Who has the authority to name beneficiaries?

The original owner names beneficiaries and contingent beneficiaries under the advice of an investment professional or tax adviser. Upon the owner's death, each beneficiary who receives RMDs may name his or her own beneficiary to receive any amounts left after the first beneficiary's death.

If multiple beneficiaries are named to one retirement account, how are the assets split into separate accounts after the owner's death?

That will depend on what the plan document provides; this is not a standard item to every document. The MFS IRA document specifies that the IRA will automatically be split into separate accounts for multiple beneficiaries after the owner's death.

How would the beneficiary's account be registered?

The account would be registered in the name of the owner for the benefit of the beneficiary. For example: Joseph Owner, deceased for the benefit of Joseph, Jr., beneficiary.

For additional information about these new rules or to obtain information about any MFS® IRA, please call MFS Retirement Plan Services at 1-800-637-1255, or visit us at mfs.com.

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IRAE-RMD-WP-2/03