1-2-3's of RMD's

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Required minimum distributions (RMDs) are annual withdrawals from tax-deferred retirement accounts mandated by the federal government once someone turns 73. Because those withdrawals are taxable it's the government's way of ensuring it receives its share of those retirement dollars that have been stored and growing tax-free in retirement accounts.

Retirement accounts that are subject to RMDs are traditional IRAs, rollover IRAs, inherited IRAs, SEP IRAs, SIMPLE IRAs, 401(k), 403(b) and 457(b)s and Keogh plans. RMDs are not required from Roth IRAs unless they have been inherited.

How much must be withdrawn

The size of your RMD is determined by the amount of money you have in eligible retirement accounts on December 31 of each year and the IRS's life expectancy estimates. (For people taking RMDs for the first time, it is the aggregated balance of all eligible accounts on December 31 of the year before they turn 73.) Richard Eisenberg, a contributor to Forbes.com, offers this about first-timers. "Most people turning 73 this year will need to tote up the balance of their RMD-eligible accounts and divide the total by the IRS's figure: 26.5," explains Eisenberg. Let's use Marshall as an example. Marshall turns 73 in May and has $500,000 in traditional IRAs. He'll need to withdraw at least $18,868 ($500,000 divided by 26.5) to meet his RMD obligation.

The following Uniform Lifetime Table shows the life expectancy for each age, 73 through 92.

First 20 Years of the Required Minimum Distribution Table

First Twenty Years of The Required Minimum Distribution Table (Uniform Lifetime)	
Age	**Distribution Period**
73	**26.5**
74	**25.5**
75	**24.6**
76	**23.7**
77	**22.9**
78	**22.0**
79	**21.1**
80	**20.2**
81	**19.4**
82	18.5
83	**17.7**
84	**16.8**
85	**16.0**
86	**15.2**
87	**14.4**
88	**13.7**
89	**12.9**
90	**12.2**
91	**11.5**
92	**10.8**

Even though the RMD reflects all of your retirement accounts, you can pay the amount due out of one IRA or any combination of IRAs (not including Roth IRAs). Employer sponsored retirement plans and inherited IRAs are exceptions to the rule. Kevin McCormally of Kiplinger explains that "if you have more than one workplace retirement plan, you must figure the RMD for each account (based on the same life expectancy factor that applies to IRAs), then withdraw separate RMDs from each account. You can't pick and choose which account to tap, as you can with IRAs."

When RMDs are due

The first RMD is due no later than April 1 of the year following the year you turn 73. In all subsequent years, the distributions must be taken by December 31. For example, if you turn 73 in March 2024 your first RMD must be made by April 1, 2025.

Because RMDs are annual events, if you delay the first withdrawal until the following year, you'll end up taking two RMDs in the same year. RMDs from your current employer's 401(k) plan can be delayed if you continue to work past age 73 and own less than 5 percent of the company.

How to lower your RMDs

Many Americans include RMDs in their retirement income plans. For others, being forced to take distributions can be problematic. In addition to increasing your annual tax bill, RMDs are considered regular income, giving them the potential to push you into a higher tax bracket. And the increase in your adjusted gross income could trigger other unpleasant consequences, such as higher taxes on your Social Security benefits, a surtax on your taxable investments, and a Medicare high-income surcharge.

They key to lowering RMDs and minimizing taxes is to do some planning in advance of turning 73.

One strategy is to begin taking withdrawals from your tax-deferred accounts when you turn 59 ½ and are no longer subject to early-withdrawal penalties. If done on a regular basis, by the time you turn 73 the size of those tax-deferred accounts will have shrunk, lowering your annual RMDs. These withdrawals can be re-invested or used as income, possibly to delay claiming Social Security, allowing Social Security benefits to increase 8 percent per year once you've reached full retirement age.

A second strategy is to systematically move funds from a traditional IRA or 401(k) into a Roth IRA as you approach age 73. You will have to pay taxes on whatever you convert, but when you retire and reach into your Roth IRA, the withdrawals will be tax-free.

Although it won't reduce the RMD amount, donating the distribution to a charity can eliminate the taxes on it. By law, taxpayers over 73 can donate up to $100,000 from their IRAs directly to a charity. Known as a qualified charitable distribution, the gift can count as your RMD and will not be considered taxable income. Employer-sponsored plans are not eligible for QCDs. Alternately, a taxpayer who itemizes can take the RMD as cash and donate it to a charity; the charitable tax deduction will offset the taxes owed on the RMD amount.

What to do with your RMDs

The federal government may insist on required minimum distributions when you hit 73 but it has relatively little to say about what you do with those distributions.

The one thing you *can't do*, is roll over your RMD into another tax-deferred retirement account. That would defeat the purpose of RMDs. The whole point of forcing you to take withdrawals is to get the money out of the tax shelter – so the IRS gets to tax the payout and any future earnings on it.

Once taxes on the withdrawal are paid, you can do whatever you want with it. RMDs are not designed to stimulate the economy so there's no requirement that you spend the distribution. If you so choose, you can immediately reinvest the RMD into a taxable account, through a bank, brokerage or other financial institution. If you don't need the money in the short-term, investments in exchange-traded funds, stocks or bonds are also possibilities.

Although the vast majority of RMDs are taken in cash, there are other options available. One popular alternative involves shares of stocks or mutual funds. You can transfer the shares to a *taxable account* as an "in-kind distribution." As far as the IRS is concerned, your withdrawal obligation is being met as long as the in-kind distribution is equal to or greater than your RMD. Of course, you will have to pay taxes on the market value of the shares on the day they were transferred. An in-kind distribution might make sense if, say, you have shares that have fallen in value but that you expect to recover. If the shares were left in an IRA, any appreciation when they're sold would be taxed at the highest tax bracket rate. But if you move the shares to a taxable account and hold them for more than a year, any post-transfer appreciation will be treated as a tax-favored long-term capital gain, with a tax rate as low as 0 percent, depending on your other income.

When an IRA owner dies

RMD rules are complicated and can get even more confusing after an IRA owner's death. "If the IRA owner has not taken the full RMD for the year prior to his or her death, the beneficiaries must take any remainder of that RMD prior to the end of that calendar year. That requirement can place a significant burden on grieving beneficiaries whose focus is on the person they've lost, not on how much money must be withdrawn from an IRA.

Different rules apply if the IRA owner dies prior to reaching the age of 73. If "the sole beneficiary is something other than a person (e.g., a charity or the estate), also called an entity beneficiary, the *entire account balance* must be distributed by December 31 of the fifth calendar year after the year of death. Non-spousal beneficiaries who inherit an IRA in 2020 or beyond fall under the new "5-Year Rule". This means that all the money in the IRA *must* be withdrawn by the end of the 5th year following the year of inheritance. At that point, the beneficiary must pay taxes on that money. Note that the rule does *not* require the beneficiary to take withdrawals *during* the 5-year period if he or she doesn't want to.

If the beneficiary is a spouse, he or she can choose either of the plans just outlined, but there are additional options. One option is to delay RMDs until the year in which the IRA owner would have turned 73, using the spouse's single life expectancy to determine the amount of the RMD. Yet another option, available only to surviving spouses, is to roll over the decedent's IRA into his or her own IRA, at which point the basic rules of IRA ownership apply.

The RMD rules we've discussed that apply after an IRA owner's cover the majority of situations – but there are more. For example, if the beneficiary is a trust it is treated like an entity beneficiary unless it conforms to a complicated set of standards established by the IRS. It can get even more confusing if there is a combination of entity and human beneficiaries. "The rules…for a sole entity beneficiary are followed by all beneficiaries (entity or human), unless the entity beneficiaries have cashed out by September 30 of the calendar year following the year of death, in which case the rules applicable to only human beneficiaries apply.

Although there are no RMDs for Roth IRAs while the owner is alive, beneficiaries are required to take withdrawals. In these situations, beneficiaries must follow the same rules that apply to beneficiaries of traditional IRAs whose owners died prior to reaching their RMD due date.

How to avoid onerous penalties

As you can see, the rules governing required minimum distributions can be confusing. The timing of withdrawals can be tricky, especially for seniors taking RMDs for the first time. For example, if you postpone your first RMD to the year after you turn 73, it's easy to forget that your second RMD is also due that year.

Another common error is not understanding the difference between the rules for IRAs and 401(k)s. If you have multiple IRAs, your RMD is based on the total amount of money in all those accounts but the RMD can be taken from one account or any combination of accounts. For multiple 401(k) accounts, the RMD has to be calculated and withdrawn for each account separately.

People 73 or older and still working are correct in thinking they can delay the RMDs on their current employer's 401(k) plan. However, they sometimes forget that even if they continue to work they must take RMDs from the 401(k) plans of previous employers plus any IRAs they may own.

Regardless of the complexity, it is essential that you adhere to the rules in order to avoid severe penalties. If you miss a deadline, you could be subject to a 25 percent penalty on the amount that should have been withdrawn. For example, if your RMD is $10,000 and you miss the deadline for taking the distribution, you will face a penalty of $2,500 on top of the taxes owed on the full amount of the RMD.

Although it's a cumbersome process, should you miss your RMD deadline you can ask the IRS to waive the penalty. The IRS can waive all or part of the penalty if it believes it was a reasonable error and you're taking steps to fix the mistake. The request for waiver may be included in a letter of explanation, which you attach to your tax return (Form 1040) along with your Form 5329.. The RMD should be taken as soon as possible and noted in the letter of explanation. When requesting a waiver, do not pay the penalty up front. Instead, follow the instructions for requesting a waiver in the Instructions for Form 5329. The IRS will often grant the waiver unless it believes you have intentionally ignored the RMD rules.

Still confused about RMDs? We can help. Give us a call at 800-277-0025 or send an email to asknoel@theprovestperspective.com

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