Career Corner

Required Minimum Distributions: A Primer

Understanding how RMDs impact retirement planning

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Contributing to retirement accounts such as a Traditional 401(k), Thrift Savings Plan, and a Traditional IRA while in working years have a nice advantage - taxes are not paid on the contribution to these accounts which lowers the current year tax liability. The retirement accounts will grow over time and are a key aspect of a family's financial plan. However, there's a specific point in retirement when the IRS steps in to say the years of completely tax-free growth are over. At that point, the IRS requires retirees to withdraw a portion of their retirement account each year and pay taxes on the distribution. This mandatory withdrawal is the required minimum distribution (RMD). If the retiree forgets to take their RMD or does not withdraw enough funds from their account, penalties can be harsh. In addition, rules for RMDs often change, and it is important to keep up to date on this important retirement planning topic. Our goal is to provide a basic understanding of RMDs to help along your financial journey.

Which retirement accounts do RMDs impact?

Essentially all tax-deferred accounts such as 401(k)s (both Roth and Traditional), Traditional IRAs, 403(b) plans, 457(b) plans, and SEP IRAs.

RMDs are not required for Roth IRAs during the account owner's lifetime. However, if someone inherits a Roth IRA, they will need to take RMDs.

What age do RMDs start?

If you were born after June 30, 1949, you do not have to take RMDs until you reach **age 72**. Previously, RMDs began at age 70½. (www.irs.gov)

What is the purpose of RMDs?

RMDs exist to produce tax revenue for the government and prevent people from accumulating excessively large retirement accounts. Many wealthy investors and retirees do not need money from their retirement accounts for everyday living expenses and would otherwise not withdraw from them. RMDs are in place to ensure a minimum, or reasonable, amount is withdrawn and taxed by the IRS.

RMD Calculation

The IRS provides worksheets to calculate your RMD. The calculation includes the balance of your account at the end of the previous year and a "life expectancy factor" table based on your age.

The important point is to ensure the calculation is correct. Oftentimes, your financial institution (such as Vanguard or Fidelity) will provide an estimated RMD in your online portal. If this is the case, it is important to double check their calculation. If you have a financial planner, they should complete the calculation and provide planning options for taking your RMD.

If you have multiple retirement accounts, RMD aggregation rules can be complex and it is important to check the rules before developing your RMD strategy. In general, RMDs must be taken from each investment account and cannot be aggregated (with the exception of Traditional IRAs). Meaning, you cannot sum the amount of your RMDs across say three different types of retirement accounts and then take that entire amount from just one account. Retirees often find benefit in consolidating all their investment accounts that require RMDs into one Traditional IRA, therefore making the RMD calculation and process much simpler.

Understanding how RMDs impact retirement planning is no day at the beach. With harsh penalties, it's important to have a plan for how you'll manage them in your retirement.

Of course, you can withdraw more than your RMD if needed. However, the excess distribution cannot be applied to future year RMDs.

What is the Penalty for missing an RMD?

The penalty for missing an RMD or not taking the full amount can be severe - 50% of the amount not taken. Many retirement accounts have grown over the years and their RMD could average, say around $50,000 per year. The penalty for not taking their RMD would be $25,000 - which is a good reason to take this topic seriously! Ultimately, it is the taxpayers responsibility, not the responsibility of the financial custodian or financial planner, to ensure an RMD is taken.

Key Deadlines

The deadline to take the first RMD is by April 1st of the year after you turn age 72. For all subsequent RMDs, the deadline is December 31st. *

If you are still working at age 72 and are contributing to a retirement plan, you may not have to take the RMD from that plan until after you retire. However, RMDs from other accounts, such as Traditional IRAs and prior employer 401(k)s, may still apply.

**In an attempt to delay RMDs as late as possible, a retiree may wait until April 1st of the year they turn 73 to take their first RMD. However, that would also require that the retiree take another RMD by December 31st of that same year, clumping two RMDs into one tax year. This bump in income can be substantial and could force a taxpayer into an unfavorable tax bracket. It may be advisable to take one RMD at age 72 and another at 73, smoothing out the income. Always consult with your tax advisor or financial planner to discuss your specific situation.*

Tax Impact of RMD

RMDs count toward taxable income for the year. For tax planning, RMDs may bump the account holder into a higher tax bracket when aggregating all income sources for the year. RMDs are accounted for by your financial custodian on tax form 1099-R, which will be mailed or available to download. RMDs appear on your tax form 1040 on lines 4a and 4b.

RMD Strategies

Many retirees rely on regular withdrawals from their retirement accounts to fund living expenses. If this is the case, they can either take their RMD in one lump sum during the year, or spread out the RMD in regular intervals throughout the year. For example, some folks withdraw a portion of their RMD monthly to meet living expenses. In this scenario, we would encourage the retiree to double check their calculations to ensure the full RMD is satisfied throughout the year.

Some retirees have multiple sources of income and do not need the funds from their RMD for living expenses. While the IRS requires retirees to withdraw from their tax deferred accounts, they don't require retirees to spend their RMDs. Let's consider a few options:

Reinvest the RMD. Retirees often invest the funds from an RMD in an after tax brokerage account. Essentially, they are taking a portion of their retirement account and placing those investments in their brokerage account, keeping their overall portfolio intact. Some folks make an in-kind transfer from their IRA to their brokerage account to maintain the shares and remain invested (though the cost basis resets to market value and taxes must be paid with outside funds.) Retirees can also use cash proceeds from the RMD to fund a Roth IRA if they meet requirements for a Roth IRA (must have earned income and meet the income threshold).

Charitable contribution. If philanthropy is part of a family's financial plan, using a portion of the RMD for a qualified charitable contribution (QCD) may make sense. When the RMD transfers directly from an IRA to a qualified charity, the funds transferred are not taxable. The maximum amount for a QCD is $100,000 per year. From a tax perspective, this is a great planning tool for an RMD and often is more tax advantageous than donating appreciated securities. Of note, a QCD cannot be made to a Donor Advised Fund (DAF).

There are also planning strategies to consider before age 72. Upon reaching age 59½, some folks with healthy tax deferred account balances make distributions from their traditional IRA with the goal of reducing the tax impact of their RMDs later in life. If they still have earned income, they can fund a Roth IRA with the distributions. This can be a good strategy from a tax perspective if it aligns with the overall financial plan.

Another strategy to consider is rooted in the nuance that the Roth TSP and any Roth 401(k) are subject to RMDs, whereas Roth IRAs are not. Retirees may find it beneficial to transfer money from their Roth TSP to a Roth IRA at age 70 or 71, thereby avoiding RMDs and allowing the tax-free growth of a Roth account to continue.

Our overall message is to make sure RMDs are properly calculated and taken during the tax year in order to avoid unnecessary tax penalties. RMDs can be a complicated topic and can involve other rules when dealing with an Inherited non-spouse IRA or 401(k). If you have questions about RMDs or other financial topics, contact us directly at rob@firesidefinances.com and shad@stamfordbridgewealth.com.

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