Required Minimum Distributions

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Summary

If you own a traditional IRA, or you have a 401(k) or other similar account through a former employer, you generally have to start taking money out of these accounts once you get into your seventies, whether you need the money or not. This paper explains why this is so and what the main rules are. It also provides some useful tips about how to handle this situation.

What are Required Minimum Distributions, or RMDs (or, as some call them, Minimum Required Distributions, or MRDs)?

The concept is really pretty simple. Congress has authorized tax breaks for certain kinds of retirement plans and products. The main reason was to encourage people to save for retirement, so that society would not be burdened with a vast number of elderly poor. But Congress did not intend this to be a total give-away. The tax breaks were not intended to last forever, or extend for multiple generations. So the government requires that once you reach a certain age, you have to start taking money out of these plans, whether you want to or not.

You donøt have to take all of the money out at once. Rather, you have to take out a certain percentage every year ó with the percentage increasing as you age. This minimum amount you have to withdraw is called a õrequired minimum distributionö because the money is being distributed from the plan to you.

Is this a bad thing? For most people, it isnøt. Most people need the money anyway, and often want to withdraw more than the minimum amount ó which they are fully entitled to do. But for those who do not need more cash to spend, there are good reasons to leave the money where it is:

- The plans in question all offer tax deferral. This means you do not pay taxes as income is earned on these accounts. Instead, you pay taxes when the earnings are withdrawn. The longer you can defer taxes, the more your money grows, because you also will earn interest on the tax money that Uncle Sam is letting you hold onto temporarily. This can make a huge difference over long periods of time. RMDs put a limit on this, so it may be in your interest to avoid them, if you can.
- When you do withdraw money from most of these retirement accounts (all but Roth IRA/401(k)/403(b)), you have to pay taxes on it, just as you do for other income. Most people find this unpleasant.
- Taxation of Social Security benefits is affected by how much other income you have. So in many cases, receiving taxable income by taking RMDs can increase the amount you are taxed on Social Security.
- Timing may also be an issue. Some years are better than others for liquidating investments. But the RMD rules require that a withdrawal occur *every* year, once you reach the right age.

What kind of plans are affected?

Required minimum distributions apply to:

- Traditional IRAs (i.e., Individual Retirement Accounts *other* than Roth IRAs).
- Most õqualifiedö employer-sponsored retirement plans. This includes 401(k) plans, 403(b) plans, Simplified Employee Pension plans and Simple Plans, and most other õdefined contributionö plans ó i.e., retirement plans that carry a balance that is owned by or assigned to you.
- Roth 401(k) and Roth 403(b) plans.

RMDøs do *not* apply to:

- Roth IRAs
- Most õnon-qualifiedö employer-sponsored plans. This includes Section 457 plans sponsored by schools, government agencies, or not-for-profit organizations. It also includes certain plans offered by for-profit companies as a special benefit to high-level employees.
- Individual annuities owned by you outside one of the previously mentioned kinds of retirement plans.
- Life insurance policies
- Bank accounts, mutual funds, or other savings or investments that you own outside of a formal, tax-sheltered retirement plan.

How RMDs work: the Basics

When RMDs start. In most cases, the so-called õRequired Beginning Dateö is the year after you turn 70½. If you are older than that but are still working for the employer sponsoring the plan in question, and assuming you do not own 5% or more of that employer, you can further postpone RMDs until the year you retire. Note, however, that since traditional IRAs are not employer-sponsored, the Required Beginning Date for them is the year after you turn 70½, *regardless* of whether you are still working.

How much you have to withdraw. There are two ways to handle this:

- The simplest way is to convert the fund to an annuity that will pay out a lifetime benefit to you. Such annuities automatically meet the RMD requirements. However, the simplest way is not necessarily best, and the decision to purchase such an annuity should be based on other factors.
- The normal way is for you to withdraw at least a certain percentage of the fund every year. The percentages are specified by the IRS and they go up as you age. Similarly, the account balance will vary. With both of these factors changing, your RMD amount will change every year, too. As a general rule, while you are still in your 70s, only 4-5% of your fund needs to be withdrawn every year, in your 80s it is more like 5-8%, and in your 90s it is about 9-15%. Lower percentages can be used if you are married and your spouse is more than 10 years younger. Financial companies holding the funds in plans requiring RMDs must

notify you every year how big a withdrawal is due. So you do not necessarily have to track this requirement yourself.

<u>What happens when you die</u>. This depends on who, if anyone, is named as the beneficiary of your account. If your spouse is the beneficiary, then the law provides for the account to be treated as the beneficiaryøs own, and RMDs will be required (or not) based on his or her age. If someone other than your spouse is beneficiary, RMDs will have to be made starting right away, based on the beneficiaryøs age. If no personal beneficiary is named, RMDs will be based on your age at death (if you have already started taking RMDs), or the entire fund will need to be paid out within 5 years (if you havenøt started taking RMDs yet). The death needs to be reported to the plan sponsor or financial institution, and then they will help with the necessary arrangements and future calculations.

<u>If you have more than one plan or account</u>. The calculations must be done for each plan. In general, the RMD calculated for each plan or account needs to be withdrawn from that plan or account. But there are two big exceptions. First, if you have multiple (non-Roth) IRA plans, the IRA withdrawals can come from any one or more of those accounts. Similarly, if you have multiple (non-Roth) 403(b) accounts, the 403(b) withdrawals can come from any one or more of the 403(b) accounts.

Tips and suggestions

— As with all areas of the tax code, there are variations and exceptions, and the plan sponsor or financial institution will not necessarily know if these apply to you. Your RMD amount could be lower than the amount they tell you. So if you want to minimize your RMDs, have your personal financial advisor review them for you.

— Since Roth IRAs are not subject to RMDs, you may wish to convert or roll over other plans to a Roth IRA if you want to avoid RMDs. For conversions from plans other than Roth 401(k) and Roth 403(b), however, this process will generate immediate and possibly substantial taxes. That could kick you into a higher tax bracket, and may also have a big effect on the taxation of Social Security benefits. Still, getting the tax hit over in one year (or perhaps spreading it over a few years) could pay off for you or your heirs in the long run, depending on your situation.

— In order to minimize required distributions after death, it is very valuable to have a beneficiary named for each plan or account, particularly if your spouse is to inherit it. Yes, your spouse might inherit the plan through your will, but if she or he is not also named as beneficiary in the retirement account itself, the account might have to be liquidated unnecessarily and perhaps disadvantageously.

— You can take RMDs any time during the year. Usually, it is best to wait until the end of the year, since that allows more time for you to earn tax-deferred interest. But keeping an eye on market conditions may enable you in some years to time your withdrawal more favorably.

— If you are still working at age 70½, and own an IRA, you have to take RMDs from the IRA, but not from your 401(k) or other plan at work. If you want to avoid RMDs on the IRA and intend to keep working for a while longer, you should consider rolling over your IRA into your 401(k) or other employer-

sponsored plan. But consider the other pros and cons first, including the fact that you will need to liquidate assets inside the IRA before you can do the rollover.

— If you have one IRA with real estate or other illiquid assets, or if you have an IRA that is performing exceptionally well, and you have another IRA that is more ordinary, remember that all of your IRA RMDs can come out of the second IRA and you can leave the first one intact. If you donøt have a second IRA, you need to keep RMDs in mind as you get older, and make sure that your IRA has enough liquid funds to pay out the necessary amounts. This is not an issue in employer-sponsored plans, where illiquid investments are not permitted.

— You can also take IRA withdrawals õin kind.ö If your IRA owns individual stocks, for example, you can have the stock certificates taken out of the IRA and re-issued to you individually. This saves you commissions on selling and then re-buying the investment, assuming you do want to keep it. You will still have to pay taxes on the fair market value of the withdrawal, but that price becomes the new tax basis for the investment.

— Although you can postpone the first RMD (and only the first) to the first quarter of the following year, this is usually not a good idea. Because of the way the calculations are done, if your account is growing you will end up having to withdraw more by waiting, and the extra few monthsø earnings will rarely make up for it. Also you double up on the income taxes you need to pay, because you end up having to make two RMD withdrawals in the same year. In rare cases this could be beneficial, but usually itøs better tax-wise to avoid spiky income patterns.

For More Information

- See IRS publication #590: õIndividual Retirement Arrangements (IRAs),ö available online at: http://www.irs.gov/pub/irs-pdf/p590.pdf.