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Demystifying Required Minimum Distributions

Tax preferenced retirement accounts, such as IRAs and employer sponsored 401(k)s, are extremely popular among Americans for many reasons such as tax benefits, creditor protections and access to financial markets. In fact, the tax benefits alone make these types of accounts one of the few gifts provided to us by the Federal tax code. Unfortunately, most of these accounts are also subject to Required Minimum Distribution (RMD) rules which require savers to transition from adding to their accounts to distributing from them once the saver turns 70.5 years old. These rules can be a bit complex for many retirees, but are incredibly important to understand and follow as the penalty for not fully adhering to the rules is steep; 50% of the amount not distributed. To make matters more complicated, the rules vary by type of account. Here's what you need to know about RMDs to be certain you don't accidentally fall on the wrong side of the rules.

What types of accounts are subject to Required Minimum Distributions?

The majority of retirement accounts are subject to RMDs. This includes Traditional IRAs, Rollover IRAs, SIMPLE IRAs, SEP IRAs, Inherited Traditional IRAs, Inherited Roth IRAs, 401(k)s, 403(b)s, and 457(b) plans. The only tax preferenced retirement accounts that aren't subject to RMDs are Roth IRAs. This is one of the reasons they're so popular for savers looking to maximize the legacy they leave for the next generation. To make things more complex however, the Roth balance of a 401(k) is subject to RMDs, so be sure to understand what types of accounts you have.

How are Required Minimum Distributions calculated?

RMDs are calculated annually by taking the year-end balance of the prior year and dividing it by the saver's remaining life expectancy taken from tables provided by the IRS and based on the age of the beneficiary at the end of that tax year. There are several different life expectancy tables depending on the type of beneficiary the saver has named. The Joint and Last Survivor table is used when your spouse is your primary beneficiary and they are more than 10 years younger than you. The Uniform Life table is used when if your spouse is not the sole beneficiary, or if your spouse is less than 10 years younger than you. Finally, the Single Life Expectancy table is used for the beneficiaries of inherited accounts. Since each retirement account has its own beneficiary designation, it's important to remember to do this calculation for each account. It's also important to remember that you can always take more than the required amount, but you can't count the excess amount against any distributions required for future years.

When do Required Minimum Distributions begin, and when must they be taken by?

Generally, your first RMD on your own retirement accounts must be taken for the tax year in which you turn 70.5 years old. You must take that first RMD by April 1st of the

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year after you've turned 70.5. From then on you must complete each year's RMD requirement by December 31st. While you are allowed to push that first RMD into the following tax year you will also have to take that year's own RMD by year end. Since the taxable income from an RMD is counted in the tax year the distribution is taken, you would be taxed on two distributions in the same year which could push you into a higher tax bracket. Your accountant can help you determine whether or not to delay your first RMD .

If you are still working at age 70.5, you may not be required to take an RMD out of your employer sponsored retirement plan, like a 401(k). Many plans allow you to delay your RMD start date until the year you retire from active employment. This delay only applies to the balance in your current employer's plan, not for IRAs or 401(k)s from previous employers. This exception also does not apply to anyone that owns 5% or more of the company they work for and does not apply to SIMPLE or SEP IRAs.

Can I use my Required Minimum Distribution to make an IRA contribution, or roll it into a different IRA?

In most cases the answer is no. You can only continue contributing after age 70.5 to certain types of accounts, assuming you still have earned income. You are permitted to make contributions after 70 in Roth IRAs, SIMPLE and SEP IRAs, and 401(k)s provided you're still working for the plan sponsor and their plan allows for the delay of your RMDs. Since SIMPLE and SEP IRAs do not qualify for delaying RMDs, this means that you would both be contributing to the account and taking distributions out of it in the same year.

Do distributions have to come from each account?

The answer to this question is dependent on the type of accounts being considered. For IRAs (including Traditional, Rollover, SIMPLE and SEP IRAs) and 403(B) plans, while you must calculate each account's RMD separately you are permitted to aggregate them for the actual distribution. This means you can take the RMD for all of your IRAs out of only one of them, or you can take them out of each account. The IRS doesn't care which IRA the distribution(s) come from, so long as the required minimum amount is taken out and, therefore, taxable.

401(k) plans and inherited IRAs (both traditional and Roth), however, require that each account's RMD be taken from that specific account's balance. You are not allowed to aggregate the balances across these types of accounts for distribution purposes.

How do inherited accounts work?

If you've inherited a tax qualified account you will typically be required to start taking RMDs. The only exception to this rule is if the account is inherited from your spouse. In that case, you are permitted, but not required, to treat the inherited account as your own. You can roll the balance into one of your own existing qualified accounts (IRA, 401(K), etc) rather than into an inherited account. RMD rules would then apply as normal. If you've inherited the account from a non-spouse then you'll be required to start taking RMDs. You have however some flexibility on how and when you take them depending on whether the now deceased original owner had passed age 70.5 and was required to take RMDs themselves. Of course the first universal option is to take an immediate lump sum payout. Doing this means you are giving up any potential tax preferenced growth on the account balance, and will incur a potentially large income tax liability (assuming the funds aren't Roth after tax dollars). These issues can be avoided by using one of the following options.

If the original owner passed away after age 70.5 you are required to start taking RMDs based on either your life expectancy or the deceased. If they were younger than you, by December 31st of the year after the original owner passed away. However, the IRS also requires that the RMD for the year of death of the original owner be processed as if they lived through the entire year. This means that if they hadn't already taken their RMD prior to passing away, you must process the distribution before the end of that year.

If the original owner passed away before turning 70.5 years old then you can either take annual distributions based on your life expectancy, like above, or you can use a 5 year lump sum method. This option allows you leave the entire balance in the inherited account for up to 5 years, growing tax deferred. However, the full account balance must be distributed by December 31st of the 5th year. This 5 year rule can also be applied to an inherited Roth account regardless of the age of original owner upon their passing

What if I miss a distribution?

As mentioned earlier, missing an RMD can be an expensive error. The IRS penalty is 50% of the missed distribution. That applies whether you miss the entire amount or just part of it and is in addition to your normal required taxes. The good news

is that the IRS does give you a way to avoid this penalty, provided the failure to withdraw the full and correct amount was due to a reasonable error, and that steps are being taken to correct the mistake. This means you would need to get the proper amount distributed and then file a form 5329 with a letter of explanation. Your accountant should be able to help you with that.

In conclusion, always remember that these rules, while complicated, can be easily followed with the help of your professional financial services team; your financial advisor and accountant. Most custodians of tax qualified accounts will also communicate with you when it's time to start taking RMDs, and most even have a system that will automatically calculate and distribute the required amount each year. Be sure to speak with your advisor if you aren't currently enrolled in such a program.

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