Understanding Required Minimum Distributions

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by David Scranton

The idea behind required minimum distributions, or RMDs, is that the government wants to give us a tax incentive to save for retirement – but they also want to make sure we don't misuse it. So, if we're in the 30% tax bracket and we put money into a tax deductible IRA or a 401k, each dollar we put in really only costs us 70 cents because it's a before-tax contribution. So the government is helping us save and that's nice. However, it's also true that the government really wants this to be retirement money. In other words, they don't want it to be money that you never spend or leave for your heirs. They want to make sure you pay tax on it eventually.

IRAs are one example of a use-specific plan, which the government loves. The 529 college tuition plan is another example; it's extremely tax-efficient for the investor if used for college, but extremely tax-inefficient if used for retirement. Similarly, IRAs are designed to encourage people to save money for retirement, and if the money is used for that purpose then it's taxed in a friendly manner. If it's used for anything else, it's not.

The challenge for the IRS in providing this incentive for retirement savings has been the same challenge faced by the Social Security administration in maintaining the system's solvency: people are living longer. Today there is a 50% chance that the average 65 year old will live into his late 80s. For the average couple aged 65, there is a 50% chance that at least one spouse would live to age 92. Logically then, the IRS doesn't want to wait until your death to get its tax money because it might end up waiting a very long time. Thus, everyone is required begin taking minimum distributions from their savings plans after age 70-and-a-half.

To the government's credit, it has actually lowered RMD percentage amounts in recent years because it recognized that increasing longevity rates were creating challenges from the other end as well, with some people legitimately worried about depleting their IRAs before they died. The bottom line is simply that the IRS doesn't want retirement income vehicles to be used as inheritance vehicles, and thus it requires you to

take minimum amounts of income from them each year once you've reached the requirement age.

When Do I Take RMDs?

Again, the general rule is that you have to start taking RMDs in the year in which you turn 70½. For example, if you turn 70½ by June 30th of this year then you must take a distribution sometime this year. If you don't turn 70 until July 1st, however, then you get to wait until next year because you're not 70½ until January. Technically, the rule is that you must take them by April 1st of the year following the year when you turn 70½, but the reality is most people don't wait until that following year because then they end up having to take two distributions in one year. As a practical matter, most people take their first RMD in the year in which they turn 70½, and then one every year thereafter.

The one exception to all of this is for someone still employed at age 70½ at a business that he does not own. When that's the case, you do not have to take required minimum distributions on that particular retirement plan. You still must take them on any other retirement plans, such as your IRA, but not on the plan that's with a company for which you are still employed at age 70½.

How Much Do I Owe?

The penalty for not taking sufficient RMDs each year after age 70½ is significant: 50 percent, so it's important to do your calculations correctly. The good news is that in addition to reducing RMD amounts in recent years, the government has also made it easier to calculate what you owe. Here is basically how it works:

-IRS Publication 590 gives you a uniform table with a government-assumed life expectancy for each age past 70. Note that your government-assumed life expectancy is actually much longer than your statistical life expectancy:

IRS Reg. 1.401(a)(9)-9, Q+A-2

Age	Distribution Period				
70	27.4	85	14.8	101	5.9
71	26.5	86	14.1	102	5.5
72	25.6	87	13.4	103	5.2
73	24.7	88	12.7	104	4.9
74	23.8	89	12.0	105	4.5
75	22.9	90	11.4	106	4.2
76	22.0	91	10.8	107	3.9
77	21.2	92	10.2	108	3.7
78	20.3	93	9.6	109	3.4
79	19.5	94	9.1	110	3.1
80	18.7	95	8.6	111	2.9
81	17.9	96	8.1	112	2.6
82	17.1	97	7.6	113	2.4
83	16.3	98	7.1	114	2.1
84	15.5	99	6.7	115 and over	1.9
		100	6.3		

-To calculate your RMDs, take the balance of your IRAs on December 31st of the previous year and divide it by this life expectancy factor.

-At age 70½, that RMD equals approximately 3.7% of your IRA balance then increases every year you get older as your life expectancy gets shorter.

While this process is simpler than it used to be, it's not totally simple. The uniform table formula above applies to unmarried IRA owners and owners whose spouses are *not* more than 10-years younger. A separate formula and a separate table exists for IRA owners whose spouses *are* more than 10-years younger, and generally their RMDs end up being less.

There are other complications as well. For instance, certain kinds of annuities have to be separated from the basic calculation, and the RMDs on them must be calculated differently. Specifically, these are annuities that are annuitized or have to be annuitized at some point in the future. These particular instruments increase the dollar amount of your RMDs and therefore also increase the amount of taxes due on them.

Another complication is that when one has IRAs but also any form of qualified plan, such as a 401(k), 403(b) or 457, the RMDs from the IRA and each of these plans must be calculated and made separately; they cannot be co-mingled. This is one of the major reasons (though not the only one) that most people roll over their qualified plans into IRAs before age 70½; it makes life simpler.

What About Taxes?

The amount of extra tax liability you have because of your RMDs depends, of course, on many factors, including your personal situation and how much income you have from other sources. The key is to understand the concept of a marginal tax bracket, which is based upon an average of all the tax brackets that you're currently in. For example, if your marginal tax bracket according to your tax preparer is currently 17.3% it's because you have maximized your 10% bracket, maximized your 15% bracket and had some income in the 25% bracket. The blended rate is an average of 17.3%. However, once required minimum distributions get stacked on top of your other income sources, your marginal tax bracket will be 25% and the RMDs will be taxed accordingly, or maybe as high as the 28% bracket. The reality is that income tax brackets for RMDs are as follows: 10%, 15%, 25%, 28%, 33%, and finally 39.6%:

Tax Bracket	Single	Married Filing Jointly	Head of Household
10% Bracket	$0 – $8,950	$0 – $17,900	$0 – $12,900
15% Bracket	$8,950 – $36,250	$17,900 – $72,500	$12,750 – $48,600
25% Bracket	$36,250 – $87,850	$72,500 – $146,400	$48,600 – $125,450
28% Bracket	$87,850 – $183,250	$146,400 – $223,050	$125,450 – $203,150
33% Bracket	$183,250 – $400,000	$223,050 – $450,000	$203,150 – $400,000
39.6% Bracket	$400,000+	$450,000+	$400,000+

But even with all this information – knowing you can add up the balances of all of your IRAs and qualified plans as of December 31st and factor those against your IRS assumed life expectancy and then determine your marginal tax bracket, etc. – there are still other factors to consider when it comes to RMDs. One of them is Social Security, and the fact that every extra dollar of taxable income generated from any source, including RMDs, might cause a greater part of your Social Security benefit to be taxed.

This is where your RMD calculation gets very challenging because it can potentially became a perpetual loop calculation that might change every year depending on your personal situation:

Filing status	Provisional income*	Amount of SS subject to tax
Married filing jointly	Under $32,000 $32,000 - $44,000 Over $44,000	0 Up to 50% Up to 85%
Single, head of household, qualifying widow(er), married filing separately & living apart from spouse	Under $25,000 $25,000 - $34,000 Over $34,000	0 Up to 50% Up to 85%
Married filing separately and living with spouse	Over 0	85%

Don't Try This at Home

Whatever that situation may be, by far and away the most important thing for you to consider regarding RMDs (as well as Social Security) is whether or not your asset allocation is suitable and sufficient to generate the amount of minimum distributions you need to satisfy your requirements. In a word, it should be generating at least 3.7% dividend or interest. If you're relying on capital gains each year for your RMDs, then in essence you're taking them from principal, which is a slippery slope that you definitely want to avoid.

While it is smart to and advisable to use IRS Publication 590 and other available information and resources, such as those provided here, to estimate your RMDs, the process of creating a sound, safe retirement plan that suits your needs and meets your goals is best done in collaboration with a qualified professional financial advisor. And in today's economic climate, an advisor who specializes in the universe of non-stock market income generating alternatives is uniquely qualified to work with you to devise a plan that satisfies your RMDs, maximizes your Social Security, and provides the kind of reliable income, reasonable growth and portfolio security you need to meet your goals with certainty and peace of mind.