FINANCIAL PLANNING

The Basics of Required Minimum Distributions: 12 Things You Must Know About RMDs

Retirement savers who are 72 must start withdrawing funds from tax-advantaged retirement accounts. Here's what you need to know about required minimum distributions and how to minimize your tax bill.

Getty Images

After decades of squirreling away money in tax-advantaged retirement accounts, investors entering their 70s have to flip the script. Starting at age 72, Uncle Sam requires taxpayers to draw down their retirement account savings through annual required minimum distributions. Not only do you need to calculate how much must be withdrawn each year, you must pay the tax on the distributions.

There's no time like the present to get up to speed on the RMD rules. Once you know the basic rules, you can use smart strategies to minimize taxable distributions and make the most of the money that you must withdraw.

Here are 12 things you should consider regarding required minimum withdrawals.

When You Must Start Taking RMDs

The SECURE Act changed when you must start taking RMDs. Under the 2019 legislation, if you turned 70 ½ in 2019, then you should have taken your first RMD by April 1, 2020. If you turned 70 ½ in 2020 or later, you should take your first RMD by April 1 of the year *after* you turn 72. All subsequent ones must be taken by December 31 of each year.

This generally applies to the original owner of a traditional IRA, SIMPLE IRA, SEP IRA or a retirement plan, such as a 401(k) or 403(b). Roth IRAs do not have RMDs.

The RMD is taxed as ordinary income, with a top tax rate of 37% for 2021 and 2022.

An account owner who delays the first RMD will have to take two distributions in one year. For instance, a taxpayer who turns 72 in March 2021 has until April 1, 2022, to take his first RMD. But he'll have to take his second RMD by December 31, 2022.

Taking two RMDs in one year can have important tax implications. This could push you into a higher tax bracket, meaning a larger portion of your Social Security income could be subject to taxes, or you could also end up paying more for Medicare Part B or Part D.

To determine the best time to take your first RMD, compare your tax bills under two scenarios: taking the first RMD in the year you hit 72, and delaying until the following year and doubling up RMDs.

How to Calculate RMDs

To calculate your RMD, divide your year-end account balance from the previous year by the IRS life-expectancy factor based on your birthday in the current year.

If you own multiple IRAs, you need to calculate the RMD for each account, but you can take the total RMD from just one IRA or any combination of IRAs. For instance, if you have an IRA that's smaller than your total RMD, you can empty out the small IRA and take the remainder of the RMD from a larger IRA.

A retiree who owns 401(k)s or 403(b)s at age 72 is subject to RMDs on those accounts, too. But unlike IRAs, if you own multiple accounts, you must calculate and take each RMD separately.

You can take your annual RMD in a lump sum or piecemeal, perhaps in monthly or quarterly payments. Delaying the RMD until year-end, however, gives your money more time to grow tax-deferred. Either way, be sure to withdraw the total amount by the deadline.

Penalties for Missing RMD Deadlines

What happens if you miss the deadline? You could get hit with one of Uncle Sam's harshest penalties—50% of the shortfall. If you were supposed to take out $15,000 but only took $11,000, for example, you'd owe a $2,000 penalty plus income tax on the shortfall.

But this harshest of penalties may be forgiven—if you ask for relief—and the IRS is known to be relatively lenient in these situations. You can request relief by filing Form 5329, with a letter of explanation including the action you took to fix the mistake.

One way to avoid forgetting: Ask your IRA custodian to automatically withdraw RMDs.

Work Waiver for RMDs

There are a number of instances where you can reduce RMDs—or avoid them altogether. If you are still working beyond age 72 and don't own 5% or more of the company, you can avoid taking RMDs from your current employer's 401(k) or 403(b) until you retire.

However, you would still need to take RMDs from old 401(k)s or 403(b)s you own. But there is a workaround for that. If your current employer's plan allows for money to be rolled into it, you could do that. Doing that means you won't need to take an RMD from a 401(k) or 403(b) until you actually retire. (You would still need to take RMDs from any traditional IRAs.)

Rollover to a Roth Account to Avoid RMDs

For those who own Roth 401(k)s or 403(b)s, there's a no-brainer RMD solution: Roll the money into a Roth IRA, which has no RMDs for the original owner. Assuming you are 59½ or older and have owned at least one Roth IRA for at least five years, the money rolled to the Roth IRA can be tapped tax-free.

Another solution to avoid RMDs would be to convert traditional IRA money to a Roth IRA. You will owe tax on the conversion at your ordinary income tax rate. But lowering your traditional IRA balance reduces its future RMDs, and the money in the Roth IRA can stay put as long as you like.

Converting IRA money to a Roth is a great strategy to start early, but you can do conversions even after you turn 72, though you must take your RMD first. Then you can convert all or part of the remaining balance to a Roth IRA. You can smooth out the conversion tax bill by converting smaller amounts over a number of years.

This can help you prevent paying more in taxes in the future. For instance, while traditional IRA distributions count when calculating taxation of Social Security benefits and Medicare premium surcharges for high-income taxpayers, Roth IRA distributions do not. And if you need extra income unexpectedly, tapping your Roth won't increase your taxable income.

Consider a Qualified Longevity Annuity Contract

A qualified longevity annuity contract, or QLAC, is an option to lower RMDs and defer the related taxes. You can carve out up to $130,000 or 25% of your retirement account balance, whichever is less, and invest that money in this special type of deferred income annuity. Compared with an immediate annuity, a QLAC requires a smaller upfront investment for larger payouts that start years later. The money invested in the QLAC is no longer included in the IRA balance and is not subject to RMDs. Payments from the QLAC will be taxable, but because it is longevity insurance, those payments won't kick in until about age 85.

Another carve-out strategy applies to 401(k)s and 403(b)s. If your 401(k) or 403(b) holds company stock, you could take advantage of a tax-saving opportunity known as net unrealized appreciation. You roll all the money out of the 401(k) to a traditional IRA, but move the employer stock to a taxable account. You will immediately pay ordinary income tax on the cost basis of the employer stock. You will also still have RMDs from the traditional IRA, but they will be lower since you removed the company stock from the mix. And any profit from selling the shares in the taxable account now qualifies for lower long-term capital-gains tax rates.

The Younger Spouse Rule

In the beginning of this story, we gave you the standard RMD calculation that most original owners will use—but original owners with younger spouses can trim their RMDs. If you are married to someone who is more than 10 years younger, divide your year-end account balance by the IRS life-expectancy factor at the intersection of your age and your spouse's age in Table II of IRS Publication 590-B.

Pro Rata Payout for RMDs

If you can't reduce your RMD, you may be able to reduce the tax bill on the RMD—that is, if you have made and kept records of nondeductible contributions to your traditional IRA. In that case, a portion of the RMD can be considered as coming from those nondeductible contributions—and will therefore be tax-free.

Figure the ratio of your nondeductible contributions to your entire IRA balance. For example, if your IRA holds $200,000 with $20,000 of nondeductible contributions, 10% of a distribution from the IRA will be tax-free. Each time you take a distribution, you'll need to recalculate the tax-free portion until all the nondeductible contributions have been accounted for.

Reinvest Your RMD

If you can't reduce or avoid your RMD, look for ways to make the most of that required distribution. You can build the RMD into your cash flow as an income source. But if your expenses are covered with other sources, such as Social Security benefits and pension payouts, put those distributions to work for you.

While you can't reinvest the RMD in a tax-advantaged retirement account, you can stash it in a deposit account or reinvest it in a taxable brokerage account. If your liquid cash cushion is sufficient, consider tax-efficient investing options, such as municipal bonds. Index funds don't throw off a lot of capital gains and can help keep your future tax bills in check.

Make an In-Kind Transfer of Your RMD

Remember that the RMD doesn't have to be in cash. You can ask your IRA custodian to transfer shares to a taxable brokerage account. So you could move $10,000 worth of shares over to a brokerage account to satisfy a $10,000 RMD. Be sure the value of the shares on the date of the transfer covers the RMD amount. The date of transfer value serves as the shares' cost basis in the taxable account.

The in-kind transfer strategy is particularly useful when the market is down. You avoid locking in a loss on an investment that may be suffering a temporary price decline. But the strategy is also useful when the market is in positive territory if you feel the investment will continue to grow in value in the future, or if it's an investment that you just can't bear to sell. In any case, if the investment falls in value while in the taxable account, you could harvest a tax loss.

Donate Your RMD to Charity

If you are charitably inclined, consider a qualified charitable distribution, or QCD. This move allows IRA owners age 70½ or older to transfer up to $100,000 directly to charity each year. The QCD can count as some or all of the owner's RMD, and the QCD amount won't show up in adjusted gross income.

The QCD is a particularly smart move for those who take the standard deduction and would miss out on writing off charitable contributions. But even itemizers can benefit from a QCD. Lower adjusted gross income makes it easier to take advantage of certain deductions, such as the write-off for medical expenses that exceed 7.5% of AGI in 2020. Because the QCD's taxable amount is zero, the move can help any taxpayer mitigate tax on Social Security or surcharges on Medicare premiums.

Say your RMD is $20,000. You could transfer the whole $20,000 to charity and satisfy your RMD while adding $0 to your AGI. Or you could do a nontaxable QCD of $15,000 and then take a taxable $5,000 distribution to satisfy the RMD.

The first dollars out of an IRA are considered to be the RMD until that amount is met. If you want to do a QCD of $10,000 that will count toward a $20,000 RMD, be sure to make the QCD move before taking the full RMD out.

Of course, you can do QCDs in excess of your RMD up to that $100,000 limit per year.

Use Your RMD to Pay Your Taxes

You can also use your RMD to simplify tax payments. With the “RMD solution,” you can ask your IRA custodian to withhold enough money from your RMD to pay your entire tax bill on all your income sources for the year. That saves you the hassle of making quarterly estimated tax payments and can help you avoid underpayment penalties.

Because withholding is considered to be evenly paid throughout the year, this strategy works even if you wait to take your RMD in December. By waiting until later in the year to take the RMD, you’ll have a better estimate of your actual tax bill and can fine-tune how much to withhold to cover that bill.

NYSUT NOTE: Do you have questions about RMDs, or other retirement-related issues? Check out the NYSUT Member Benefits Corporation-endorsed Financial Counseling Program, which offers access to a team of Certified Financial Planners® and Registered Investment Advisors who can provide financial counseling services customized specifically for you. For more information or to enroll, visit the website today.

Kiplinger