



## RETIREMENT PLANNING

How Lifetime Required Minimum Distributions Work

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### HOW LIFETIME REQUIRED MINIMUM DISTRIBUTIONS WORK

#### The Facts

- ◆ Participants in qualified retirement plans and most individual retirement accounts or annuities (IRAs) cannot enjoy tax-deferred earnings indefinitely. Eventually, they must begin taking required minimum distributions (RMDs) from their accounts every year.
- ◆ The latest date for taking the first RMD is April 1 of the year following the year in which the account owner reaches age 72.
- ◆ Participants owning 5% or less of the company maintaining an employee retirement plan can delay their first RMD until April 1 of the year following the year they actually retire, if later than age 72. Postponement until actual retirement age is not available to IRA owners.
- ◆ It may be prudent to take the first RMD by December 31 of the year the account owner reaches age 72. An account owner who delays taking the first RMD until April 1 of the following year must take the second RMD no later than December 31 of the same year. Taking two RMDs in the same tax year may not be the most advantageous way to take distributions from these accounts.
- ◆ Failing to take an RMD generates a hefty penalty tax of 50% of the amount that should have been withdrawn. For example, an owner who should have withdrawn a \$40,000 RMD but instead took only \$30,000 would owe a \$5,000 penalty (50% of the additional \$10,000 the owner should have taken but didn't).
- ◆ An owner always has the option to withdraw more than the required minimum.

#### The Tax Picture

- ◆ The owner of a traditional IRA or a participant in an employer-sponsored retirement plan must include RMDs in gross income as they are paid out.
- ◆ The owner of a Roth IRA may generally withdraw contributions tax free at any time if the account has been held for at least 5 years and the withdrawal is made after age 59½. If the withdrawal is made before the 5-year period or age 59½, income taxes and a 10% penalty tax may apply.



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- ◆ Any tax basis included in the distribution is received tax free. However, IRA owners or participants in a company retirement plan will generally not have a tax basis unless they: (1) made nondeductible IRA contributions, (2) made after-tax contributions to their employee retirement plan accounts, (3) elected to deem a portion of their deferrals as Roth deferrals (if allowed under the plan), or (4) reported a yearly taxable economic benefit for life insurance provided through a retirement plan account.

### The Annual Amounts

- ◆ Owners who don't need the withdrawals to maintain a standard of living often prefer to keep distributions as low as possible, deferring taxation and enjoying continued compound earnings on funds remaining in the account.
- ◆ The IRS provides a table of factors—the Uniform Lifetime Table—that is used to make the annual RMD calculation in most situations, based on the owner's age.

### Potential Survivors

- ◆ If a spouse is more than 10 years younger than the owner and would be the sole beneficiary of the account at the owner's death, the Joint Life Table (rather than the Uniform Lifetime Table) is used to calculate RMDs during the owner's life.
- ◆ Use of the Joint Life Table results in lower RMDs during the owner's lifetime, keeping more in the account to benefit a spouse who may outlive the owner by many years.
- ◆ After an account owner's death, "Eligible Designated Beneficiaries" (surviving spouses, minor children, beneficiaries not more than 10 years younger than the decedent, and those disabled or chronically ill) may take RMDs over their remaining life expectancies. All other designated beneficiaries must withdraw the entire amount within 10 years of the account owner's death (although no RMDs are required during that time).
- ◆ All non-individual designated beneficiaries, such as charitable organizations or estates, must withdraw all amounts within 5 years of death if RMDs have not begun.



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### HOW LIFETIME REQUIRED MINIMUM DISTRIBUTIONS WORK

#### The Bottom Line

The rules for required minimum distributions—particularly post-death RMDs—are complex and should be reviewed with a trusted advisor. In determining a strategy, a key objective is often to keep each year's distribution to the minimum amount required—particularly in situations where maximum distributions are not needed to maintain a standard of living. This avoids the tax penalty while retaining more in the account to enjoy continued tax deferment and compound earnings.



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## SUMMARY

### WHAT ARE REQUIRED MINIMUM DISTRIBUTIONS?

Participants in tax-deferred employee retirement plans and most IRAs (SEP, SIMPLE and traditional) cannot accumulate tax-deferred earnings indefinitely. Eventually, they must begin taking required minimum distributions (RMDs) from their accounts. Failure to do so will add a 50% penalty tax to the amount that they should have withdrawn, but did not.

**Example:** An account owner reaching the required age needs to withdraw \$40,000 from the account to comply with RMD rules, but only takes out \$30,000. The result is a penalty tax of \$5,000 (50% of the \$10,000 the owner failed to take).

### WHEN MUST RMDs BEGIN?

RMDs must begin by April 1 of the year following the year in which the owner reaches age 72. It may be prudent to take the first RMD by December 31 of the year the account owner reaches age 72. An account owner who delays taking the first RMD until April 1 of the following year must still take the second RMD by December 31 of the same year. Taking two RMDs in the same tax year may be disadvantageous.

An exception: employees owning 5% or less of the company maintaining the retirement plan can typically delay their start date until April 1 of the year following the year they actually retire, if that is later than age 72. Postponement until actual retirement is not available to IRA owners.

### HOW ARE RMDs TAXED?

RMDs are included in the taxpayer's gross income when they are paid out, with a tax-free recovery of basis if part of the distribution reflects an investment made with after-tax dollars. Usually, however, there will be no tax basis in the account unless the owner made nondeductible contributions or reported a yearly taxable economic benefit for life insurance provided through the agreement.



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Account owners who don't need distributions to maintain a standard of living usually prefer to leave as much in their accounts as possible.

### HOW IS THE RMD AMOUNT DETERMINED?

To determine how much must be withdrawn annually to comply with RMD rules, the IRS provides a series of numeric factors in its Uniform Lifetime Table. The factor for the owner's age is divided into the account balance at the end of the preceding year, with the result reflecting the RMD in most (but not all) situations.

**Example:** At age 75, the factor in the Uniform Lifetime Table is 22.9. If the owner's account balance on the preceding December 31 was \$1 million, the required minimum distribution would be \$43,668.12.

### WHAT IF THE ACCOUNT OWNER HAS POTENTIAL SURVIVORS?

If the account owner has a spouse who is more than 10 years younger and the sole beneficiary of the account, the Joint Life Table may be used instead of the Uniform Lifetime Table to calculate RMDs during the owner's life. This generally creates lower RMDs during the owner's lifetime, keeping more in the account to benefit a spouse who may survive the owner by many years.

After an account owner's death, survivors must continue to take RMDs from the account to avoid the 50% penalty tax. "Eligible Designated Beneficiaries" (surviving spouses, minor children, beneficiaries not more than 10 years younger than the decedent, and those disabled or chronically ill) may take RMDs over their life expectancies. All other designated beneficiaries must withdraw the entire amount within 10 years of the account owner's death (although no RMDs are required during that time).

All non-individual designated beneficiaries, such as charitable organizations or estates, must withdraw all amounts within 5 years of death if RMDs have not begun.

