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The ABCs of RMDs

You've struck a deal with Uncle Sam. In order to be more self-sufficient during your retirement, he's allowed you to delay paying taxes on some of your income while letting that money compound and grow tax-deferred in a retirement account.

The agreement can play out for many years, but if you think he is going to forget that you owe him money in the first place, then you don't know Uncle Sam that well. Eventually collection time will come, and you can either pay the man what you owe or pay him significantly more than what you owe by ignoring your distributions and incurring unnecessary penalties.

The inevitable collection time is triggered when you turn 70.5 (making your half-birthday relevant for the first time since elementary school), and it is manifested in a Required Minimum Distribution, or RMD. The RMD rule relates primarily to Traditional IRAs,[1] which are funded with pre-tax income or qualified retirement plan rollovers. Taxes are not incurred until money is withdrawn from the retirement account, allowing it to grow tax-deferred. The RMD was established to assure the government that you will ultimately withdraw money from your IRA and, therefore, start paying taxes on it. So, beginning with the year you turn 70.5, you are ***required*** to take a ***minimum*** annual ***distribution***, regardless of whether you actually need the money at that time.

If you thought the rules about putting money into your IRA were complicated, you're in for quite a treat when you try to wrap your head around the regulations about removing those funds.[2] Your RMD for a given year is calculated based on your IRA balance as of December 31 of the previous year, and the deadline for taking it is December 31 of the current year. You can withdraw monies at any time and in as many increments as desired throughout the year, but the aggregate distribution must meet the minimum requirements by the deadline.[3]

To soften the initial blow, the government allows a one-time, three-month grace period for your first RMD, which pushes the deadline to April 1 of the year after you turn 70.5. While this grace period seems like a positive, it can create unwanted tax consequences. It delays your first RMD, but the deadline for your second RMD does not change, leaving you to take two RMDs in that first year and potentially bumping you into a less desirable tax bracket.

You can certainly choose not to take advantage of the grace period, and this is a decision that should be made with the guidance of your advisor, who can help to identify the pros and cons of each scenario. You can also withdraw more than your required minimum; there is no maximum. The key is to ensure you take each RMD by its deadline. Failure to do so brings severe consequences, as the government assesses a steep 50% penalty on the balance of any RMD that has not yet been distributed.

In Exhibit 1, we've provided an example based on two celebrities who are about to enter the RMD phase of their lives. This example illustrates that being born in the second half of the year is more favorable as it relates to RMDs. Going forward, both Streep and Gere will be required to satisfy minimum distributions until they've depleted their IRAs or they pass away, leaving their IRAs to successors.

EXHIBIT 1 **RMD SCHEDULE EXAMPLE:**
BIRTHDAY IN FIRST HALF OF YEAR VS. SECOND HALF OF YEAR

	Meryl Streep	Richard Gere
Birthdate	June 22, 1949	August 31, 1949
Turns 70.5	December 22, 2019	March 1, 2020
First RMD Due	December 31, 2019 (April 1, 2020 with grace period)	December 31, 2020 (April 1, 2021 with grace period)
First RMD Based On	December 31, 2018 IRA Balance (regardless of grace period)	December 31, 2019 IRA Balance (regardless of grace period)
Second RMD Due	December 31, 2020	December 31, 2021
Second RMD Based On	December 31, 2019 IRA Balance	December 31, 2020 IRA Balance

Source: RMB Capital

In the instance of an inherited IRA, another layer of rules is set into motion. Once an IRA has been passed to a successor, the IRS doesn't want to lose out on the RMD it was either set to receive or had already begun receiving. We are left with a "choose your own adventure" web of RMD options (Exhibit 2). In these scenarios, the beneficiary's age becomes a relevant component. Because the RMD calculation is based on life expectancy, the older you are, the bigger your RMD as a percentage of your IRA. So, all other things being equal, an IRA will last the longest if it is passed to the youngest possible beneficiary. This planning strategy is commonly referred to as "stretching" an IRA. Since distribution rules on inherited IRAs are based on so many variables, beneficiary designation becomes an important estate planning topic.

EXHIBIT 2 **RMDs ON INHERITED IRAs**

IRA Beneficiary	IF the IRA owner passes away **before** taking RMD, OR IF the IRA is an inherited Roth IRA:	IF the IRA owner passes away **after** taking RMD:
Surviving Spouse	THEN choose one: » Rollover to IRA in spouse's name » Take payouts on deceased owner's original RMD schedule using surviving spouse's life expectancy » Deplete IRA in 5 years	THEN choose one: » Rollover to IRA in spouse's name » Take payouts based on greater of surviving spouse or deceased owner's life expectancy
Non-Spouse Individuals (Children, Grandchildren, etc.)	THEN choose one: » Take payouts on oldest beneficiary's life expectancy » Split IRA for each beneficiary, allowing each beneficiary to use his/her own life expectancy (IRA must be split by December 31 of year following owner's death) » Deplete IRA in 5 years	THEN choose one: » Take payouts on oldest beneficiary's life expectancy or deceased owner's life expectancy » Split IRA for each beneficiary, allowing each beneficiary to use his/her own life expectancy (IRA must be split by December 31 of year following owner's death) » Deplete IRA in 5 years
Entities (Estate, Charity, Trust)	THEN: » Deplete IRA in 5 years	THEN: » Take payouts based on deceased owner's life expectancy

Source: Pioneer Investments U.S.

Out of the many milestones people have in their lives, turning 70.5 is usually not at the top of the list. Nobody I know has ever received a cake for being RMD eligible, and the IRS doesn't send a postcard reminding you to take your distribution. It's up to you and your financial advisor to ensure you comply with the rules. You've done a great job at taking advantage of Uncle Sam's bargain up to this point. As long as you satisfy your minimum distributions, your IRA can be a key component of your retirement plan. ■

1 *There is no required minimum distribution during the life of a Roth IRA owner, but RMDs will apply to inherited Roth IRAs. Since qualified distributions from these accounts are not taxable, the government is less concerned about their depletion.*

2 *Many of the same RMD rules apply to employer-sponsored retirement plans, such as a 401(k). These plans will likely allow you to delay taking your RMD if you are still working past the age of 70.5, as long as you are not a 5% owner of the company. To find out more information about your company's plan, contact your 401(k) administrator.*

3 *Conversions from Traditional IRAs to Roth IRAs do not count toward the required minimum distribution.*