Mesirow

Planning strategies for required minimum distributions

Tax-advantaged investment accounts are an invaluable tool for the management of our clients' wealth. These vehicles shelter ongoing investment growth from taxes, and may provide a tax benefit for contributions or withdrawals.

Investment accounts, such as Roth IRAs and after-tax employer-sponsored retirement plans, provide for "delayed gratification" in that they are funded with after-tax dollars, grow tax free, and withdrawals are not subject to taxation.

However, other types of accounts, including Traditional IRAs and pre-tax employer-sponsored retirement plans (like your 401(k) plan), provide an immediate tax benefit as contributions are excluded from current taxation. Investments held in these accounts grow tax free, but withdrawals are treated as taxable income. Once you turn 72 (or age 70½ if you were born on or before June 30, 1949), the IRS requires you to take a certain amount of money out of these types of retirement accounts every year. These distributions are called "required minimum distributions" (or, simply, "RMDs").

Types of accounts subject to RMDs

RMD rules generally apply to investments held in the following types of accounts:

- Traditional IRAs
- Simplified Employee Pension plans (SEPs)
- SIMPLE IRAs
- Traditional 401(k) plans
- 457 plans
- 403(b) plans

Important things to remember about RMDs

- The annual RMD amount is based upon the previous year-end account value and an IRS-published life expectancy factor. This amount is subject to ordinary income federal income taxes, but may be exempt from state taxation. Note: In most cases, the life expectancy factor is based upon the account owner's age; however, if the account owner's spouse is more than 10 years younger and is named as the IRA's sole beneficiary, joint life expectancy factors can be used. As actuarial joint life expectancies are greater than single life calculations, this allows for tax deferral over longer periods of time.
- The aggregate RMDs for all of an individual's IRAs can be taken from one IRA account.
- RMDs for most employer-sponsored retirement plans must be distributed from the 401(k) for which it was calculated.
- Generally, these required distributions must be completed by year-end. However, there are two opportunities for an account owner to delay the RMD requirement.
    - If your 72nd birthday is this year, your first RMD can be postponed into the next calendar year (delaying taxation), as long as it is completed by April 1st (of the next year). However, the second RMD must still be distributed by December 31st. If you were born on or before June 30, 1949, your first RMD would have been due by April 1st of the year following your 70½ birthday.
    - Active employees can postpone RMD requirements from their employer-sponsored retirement account indefinitely as long as they are working. Note that this is only available for the accounts held in the current employer's plan, not for their IRA accounts or other plan assets.

Be careful to follow the rules

It is important to follow the rules for taking required minimum distributions from tax-advantaged investment accounts, since the IRS may levy a 50% tax penalty on the amount of the RMD that should have been distributed, but wasn't. This is in addition to the ordinary income tax liability. For example, in the event that a taxpayer in the highest marginal bracket fails to take their required distribution, federal taxes of up to 89.6% could be charged!

What you can do if you don't need the cash from your RMD

Each of our clients' tax planning situations is unique. We work with our clients and their tax advisors to determine whether it is appropriate to submit state and/or federal tax withholding payments from taxable distributions from their IRA and other qualified retirement accounts. In some cases, our clients do not need the cash flow generated by their RMDs to support their retirement lifestyle.

"In kind" transfers

For these clients, we may recommend that the required distribution be processed as an "in kind" transfer of an existing investment. When an "in kind" distribution is used, shares of a stock, bond or mutual fund, are transferred from a qualified account to a non-qualified account. The reported taxable distribution is the market value of these shares on the date of the transfer. Once this is complete, the cost basis for the transferred shares is set to the taxable distribution amount.

"Qualified Charitable Distributions" (QCDs)

Charitably-minded investors subject to RMDs can take advantage of qualified charitable distributions (QCDs) where some or all their distribution (including, but not limited by, their RMD) is donated directly to a charity. In these situations, the amount donated can be used to satisfy the annual RMD requirement, but is excluded from taxable income. This approach is limited to $100,000 per year, and in most cases, is more advantageous than receiving a taxable distribution and donating cash to a charity.

Roth IRA conversions

Another strategy is to convert some or all of a Traditional IRA (subject to RMDs) to a Roth IRA (which is not subject to RMDs). In these situations, a taxpayer elects to pay ordinary taxes on a portion of their IRA to "convert" this amount to a Roth IRA account. This conversion is not subject to early withdrawal penalties (for account owners younger than age 59½) and is available to anyone regardless of income limitations. The converted amount (and its anticipated growth) is sheltered from RMDs in future years, reducing long-term taxes paid.

Next steps

Whether you're turning 72 this year, or have been taking your RMDs for a while, it might make sense to talk with your Mesirow wealth advisor about how best to manage your RMDs based on your unique situation.

We work with our clients to understand their goals, including objectives to provide for their retirement lifestyle income needs. By working with our clients and their tax advisors we plan, implement, and monitor strategies to balance short- and long-term tax planning with each individual's and family's specific situation.

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