Managing RMDs From Tax-Advantaged Retirement Accounts

Of the mistakes older Americans can make in managing their retirement savings, failing to take required minimum distributions (RMDs) from qualified retirement accounts, like IRAs and 401(k) accounts, is among the most serious. Retirees over age 70½ are generally responsible for withdrawing the correct amount of RMDs on time every year from their accounts, and face a stiff penalty of 50% if they fail to do so. To avoid incurring penalties, while minimizing the amount of taxes owed, you may want to craft a strategy for managing your accounts that are subject to RMDs.

RMDs are the minimum amounts that you as a retirement plan account owner must withdraw annually starting with the year when you reach age 70½, or, if later, the year when you retire. If you are still employed at age 70½, you can delay taking distributions from your active 401(k) account. If, however, the retirement plan account is an IRA or if you are a 5% owner of the business sponsoring the retirement plan, you must begin taking RMDs once you reach age 70½, regardless of whether you are retired. The RMD rules apply to all traditional IRAs and all employer-sponsored defined contribution retirement plans, such as 401(k) and 403(b) plans. The minimum distribution rules also apply to Roth 401(k) accounts, but not to Roth IRAs while the owner is alive.

If you have an IRA or other qualifying account, you must take your first required minimum distribution for the year in which you turn age 70½. However, the first payment can be delayed until April 1 of the year following the year in which you turn 70½. For all subsequent years, you must take the RMD by Dec. 31 of the year. The RMD is calculated for each account by dividing the prior Dec. 31 balance of the IRA or retirement plan account by a life expectancy factor the IRS publishes in tables in Publication 590. If you fail to take a RMD or to withdraw the full amount of the RMD by the applicable deadline, the amount not withdrawn is taxed at 50%.

As the custodial firms that administer your retirement accounts are obliged to report your required RMDs each year to the IRS as well as to you, the IRS will be aware of your RMD obligations. If you have multiple accounts, you must add together your RMDs from all of your accounts to determine the total distribution amount you are required to take. However, that the total amount may be taken from any one or any combination of IRAs. If, for example, you have an IRA that is earning lower interest than the others, you may want to take the full RMD amount from that account, while leaving the other IRAs intact.

If you notice you have neglected to take an RMD or failed to withdraw the full amount, you should generally take the missing distribution immediately. You should also file Form 5329 with your federal tax return for the year in which the full amount of the RMD was not taken. The IRS may agree to waive part or all of the 50% penalty if you can show in a letter of explanation that any shortfall in distributions was due to “reasonable error,” and that you are taking “reasonable steps” to remedy the shortfall.

While it is important to take RMDs within the deadline, delaying distributions for as long as possible can be the best strategy if you do not need the income, as the assets held in the accounts will continue to grow on a tax-deferred basis. After age 70½, you may also have the option of transferring up to $100,000 of your IRA distributions directly to a charity, excluding private foundations and donor-advised funds. By taking advantage of this rollover option, you will not be entitled to an income tax deduction for the charitable contribution, but you will avoid having to pay income tax on the distribution, and you may become eligible for certain tax deductions, as the funds will not be included in your adjusted gross income (AGI).

If you wish to avoid RMDs altogether, you may also want to consider converting a traditional IRA to a Roth IRA. In the past, there were income restrictions on conversions, but since 2010 all IRA owners have been permitted to convert their accounts to a Roth. The Roth IRA option may be particularly attractive if you wish to pass on your tax-free savings to their children. You will have to pay federal income taxes on the conversion, and, if you are over age 70½, to take the RMD for the year before making the conversion. But while your heirs will be required to take distributions from the Roth IRA, they will not owe taxes on the account.

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