Required Minimum Distributions

Special Report

Understanding what they are, who is required to take them, and how to calculate them.

A GUIDEPOST PRODUCED BY AMERICAN RETIREMENT ADVISORS
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Introduction:

As you edge closer to retirement, the management of your retirement savings becomes increasingly significant. One essential aspect of this management is understanding Required Minimum Distributions (RMDs). These are withdrawals that the U.S. government mandates you to start taking from your retirement accounts once you reach a specific age. Notably, these distributions also influence inheritance planning, where lack of foresight could result in significant tax implications.

This whitepaper simplifies the complex language found in IRS Publication 590-B and discusses updates introduced by the SECURE 2.0 Act effective for the 2024 tax year. Our aim is to transform the dense governmental jargon into straightforward, easily understandable terms.

By demystifying the calculation and management of RMDs, we equip you with the knowledge to make informed decisions about your retirement savings. While this paper does not substitute for legal or tax advice, it lays the groundwork for you to seek further professional guidance with confidence. Whether you are planning for your future or assisting a family member with theirs, a clear understanding of RMDs is crucial for optimizing your financial strategy and ensuring that your retirement funds are fully prepared to support you when needed.

Let's dive into the details.

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Section 1: Understanding Required Minimum Distributions

What Are Required Minimum Distributions (RMDs)?

- **Definition**: Required Minimum Distributions (RMDs) are the minimum amounts you must withdraw annually from your retirement accounts after reaching a specific age, as mandated by the IRS. We will cover how to calculate these amounts in section 2 of this document.

Who Needs to Take RMDs?

- **Account Holders**: Anyone who owns tax-deferred retirement accounts such as an IRA, 401(k), 403(b), and other defined contribution plans. This includes special rules for inheritances!

- **Starting Age**:
    - If you were born on or before June 30, 1949, you must start taking RMDs at age 70½.
    - If you were born between July 1, 1949, and December 31, 1950, the age is 72.
    - If you were born after January 1, 1951, the age is 73.
- **Special Cases**: Roth IRAs do not require RMDs during the owner's lifetime. However, beneficiaries of inherited Roth IRAs must follow RMD rules.

- **Inherited IRAs:**

    - **Option 1:** If a beneficiary inherits an IRA, they may choose to treat the account as their own if they are the spouse of the deceased. In this case, the RMD schedule will apply to them as it would with any other account they own.

    - **Option 2:** Alternatively, the beneficiary can elect to keep the account as an inherited IRA. Under the SECURE Act, most non-spouse beneficiaries must deplete the account within 10 years following the death of the original account owner. This rule applies to deaths occurring after December 31, 2019.
        - Exceptions include minor children, disabled individuals, chronically ill inheritors.

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When Must You Take Your First RMD?

- **Timing**: You must take your first RMD by April 1 of the year following the year you reach age 73 (or age 72 if you were born before January 1, 1951)
- **[SEE EXAMPLE ON PAGE 10)**

- **Inheritance RMD Timing**: The timing of when the account holder passed away also influences RMD rules, especially after recent changes from the SECURE Act. For instance, for deaths after 2019, most non-spouse beneficiaries are required to withdraw the entire balance of an inherited IRA within 10 years after the death of the original IRA owner.

What Happens If You Don't Take RMDs?

- **Penalty**: The SECURE 2.0 Act has reduced the penalty to 25%, from 50% starting in 2023, with a further reduction to 10% if the shortfall is corrected within two years. (https://www.irs.gov/retirement-plans/retirement-plan-and-ira-required-minimum-distributions-faqs)

How Are RMD Amounts Calculated?

- **Account Balance and Life Expectancy**: The RMD amount is calculated using the account balance as of December 31 of the previous year divided by a life expectancy factor that the IRS publishes in its life expectancy tables (explained on page 5)

Key Considerations for Managing RMDs:

- **Withdrawal Strategy**: While you must withdraw at least the minimum amount, you can always withdraw more if needed. However, remember that withdrawals are generally taxable as ordinary income.

- **Tax Planning**: Proper planning can help manage the tax implications of RMDs, potentially integrating with your broader retirement strategy to optimize your financial well-being

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Section 2: Calculation Methods – Determining your RMD

Understanding how to calculate Required Minimum Distributions (RMDs) is crucial for effective retirement planning. This section will guide you through the methods used to compute RMD amounts based on IRS regulations.
The full document from the IRS linked here: https://www.irs.gov/pub/irs-pdf/p590b.pdf

Fundamental Components of RMD Calculations:

1. **Account Balance**: Determine the account balance as of December 31st of the year before the year for which the RMD is calculated. This is the starting figure for your RMD calculation.

2. **Distribution Period**: The distribution period is derived from IRS life expectancy tables. The specific table used depends on the account holder's situation as described in the three key IRS tables below.

Key IRS Tables Used in RMD Calculations:

- **Uniform Lifetime Table**: Most used by account holders unless a spouse is the sole beneficiary and more than 10 years younger. (IRS Pub 590b, Page 48)

- **Single Life Table**: Used by beneficiaries of retirement accounts for calculating post-death RMDs. (IRS Pub 590b, Page 50)

- **Joint Life and Last Survivor Table**: Used if the sole beneficiary is the spouse of the account holder and is more than 10 years younger. (IRS Pub 590b, Page 65)

Step-by-Step RMD Calculation Process:

1. **Identify the Appropriate Table**: Choose the life expectancy table based on your specific circumstances as outlined above.

2. **Find Your Distribution Period**: Locate your age on the selected table to find the corresponding distribution period (life expectancy).

3. **Calculate the RMD**: Divide the account balance as of December 31st of the previous year by the distribution period. The result is the amount that must be withdrawn for the year.

$$RMD = \frac{Account\ Balance\ as\ of\ December\ 31}{Distribution\ Period\ found\ in\ Life\ Expectancy\ Tables}$$

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Example Calculation Using the Uniform Lifetime Table:

- Suppose you are 75 years old, and the balance in your IRA as of December 31st last year was $100,000. According to the Uniform Lifetime Table, the distribution period for a 75-year-old is 24.6 years. Referencing the equation on the previous page and the uniform lifetime table on Appendix B in IRS publication 590-B.

$$RMD = \frac{\$100{,}000}{24.6} = \$4{,}065.04$$

- Calculate the RMD by dividing $100,000 by 24.6, which equals $\$4{,}065.04$.

Special Considerations:

- **Multiple Accounts**: If you have more than one retirement account, you must calculate the RMD for each account separately. However, you may choose to withdraw the total amount from one or a combination of accounts.
- **RMD Deadline**: Your first RMD must be taken by April 1st of the year following the year you reach the required age, with subsequent RMDs due by December 31st each year.

Adjustments and Updates:

- The IRS may update life expectancy tables to reflect changes in average lifespans. Always verify that you are using the most current table for your calculations.
- If there are any rollovers or contributions after December 31st, they should be considered in the next year's RMD calculation.

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Section 3: Practical Examples – Applying RMD Calculations

Understanding RMD calculations through practical examples can significantly help in grasping how these rules apply in real-life situations. Below, we'll explore several scenarios that retirement account holders might encounter.

Example 1: Standard RMD Calculation for an IRA Holder

- **Scenario**: Alice is 75 years old and has an IRA with a balance of $120,000 as of December 31 of the previous year.
- **Action**: Using the Uniform Lifetime Table (found on Page 65 of the IRS document).
- **Calculation**:
  - The distribution period for a 75-year-old according to the Uniform Lifetime Table is 24.6 years.

$$RMD = \frac{\$120{,}000}{24.6} = \$4{,}878.05$$

- **Outcome**: Alice must withdraw at least $4,878.05 from her IRA during the year and it will be taxed as ordinary income.

Example 2: Inherited IRA with 10-Year Rule

- **Scenario:** Bob inherited an IRA from his aunt who passed away last year. Bob is 53 years old.
- **Action:** Under the SECURE Act, Bob must deplete the inherited IRA within 10 years.
- **Option:** Bob can choose to withdraw amounts annually or wait until the end of the 10-year period. If he waits, he must withdraw the entire balance by the 10th year.
- **Calculation**: If Bob decides to withdraw the balance gradually, he might use the Single Life Expectancy Table as a guideline. For a balance of $200,000 and a life expectancy of 31.4 years, a hypothetical annual RMD for the first year would be:

Hypothetical Annual RMD:

$$\text{RMD to deplete in 10 years} = \frac{\$200{,}000}{10} = \$20{,}000$$

- **Outcome:** Bob must ensure the entire balance is withdrawn within 10 years, regardless of the annual distribution amounts.

Note: In some cases when the IRAs are transferred the first RMD is taken at the time of the transfer

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Example 3: RMD Calculation for a Spouse Who is More Than 10 Years Younger

Scenario: Charles is 78 years old, and his wife Diana, who is the sole beneficiary of his IRA, is 62 years old. Diana is more than 10 years younger than Charles, which allows Charles to use the Joint Life and Last Survivor Expectancy Table for calculating his RMD.

Action: Use the Joint Life and Last Survivor Expectancy Table (Table II) located on Page 50 of the IRS document. This table provides a life expectancy factor based on the ages of both Charles and Diana.

Calculation:

1. **Identify the joint life expectancy factor:** According to the Joint Life and Last Survivor Expectancy Table, the joint life expectancy for a 78-year-old and a 62-year-old is **26.4 years**.
2. **Calculate the RMD:** Using the IRA balance as of December 31st of the previous year, which is $150,000. The RMD is calculated by dividing the account balance by the joint life expectancy factor:

$$\boldsymbol{RMD} = \frac{\$150{,}000}{26.4} = \$5{,}681.82$$

Outcome: Charles should withdraw at least $5,681.82 from his IRA during the year to satisfy the RMD requirement.

Detailed Explanation: Using the Joint Life and Last Survivor Expectancy Table: This table is specifically designed for situations where the spouse is more than 10 years younger and is the sole beneficiary. It allows the account holder to use a longer life expectancy period, which can reduce the amount of the required annual distribution.

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Example 4: Delaying Your First RMD

Scenario: If you turn 73 in 2024, you have the option to delay your first RMD until April 1 of the year following the year you turn 73.

Action: You must take your first RMD by April 1, 2025. This RMD is for the year 2024. Your second RMD, which is for the year 2025, is due by December 31, 2025.

Calculation:

- First RMD: Calculate your RMD for 2024. Assume your IRA balance as of December 31, 2023, is $100,000, and the distribution period for a 73-year-old is 26.5 years (according to the Uniform Lifetime Table):

$$First\ RMD = \frac{100{,}000}{26.5} = \$3{,}773.58$$

- Second RMD: Calculate your RMD for 2025. Assume your IRA balance as of December 31, 2024, is $96,000, and the distribution period for a 74-year-old is 25.5 years:

$$Second\ RMD = \frac{96{,}000}{25.5} = \$3{,}764.71$$

Outcome:

- In 2025, you will need to take two RMDs:
    1. First RMD: $3,773.58 by April 1, 2025, for the year 2024.
    2. Second RMD: $3,764.71 by December 31, 2025, for the year 2025.

Detailed Explanation:

- Taking Two RMDs in One Year: If you delay your first RMD until April 1, 2025, you will have to take both your 2024 RMD and your 2025 RMD in the same calendar year, 2025. This could potentially increase your taxable income for that year.
- Tax Planning Considerations: Consult with a financial advisor to understand the tax implications and determine the best strategy for taking your RMDs.

Section 4: Calculation Methods

Understanding the broader implications of RMDs and employing strategic management can minimize taxes and penalties while maximizing retirement savings. This section discusses key considerations and strategies for effectively managing Required Minimum Distributions.

Implications of Missing an RMD

- **Penalties:** The IRS imposes a penalty for failing to take RMDs on time. Under the SECURE 2.0 Act, the penalty is reduced to 25% from 50%, of the amount that should have been withdrawn but wasn't. If the missed RMD is corrected within two years, the penalty is further reduced to 10%.
  - **Example**: If an RMD of $10,000 is missed, the standard penalty would be 25%, or $2,500. If corrected in a timely manner, the penalty would be reduced to 10%, or $1,000.
- **Summary of Changes Due to SECURE 2.0 Act:**
  - Penalty Rate Reduced: From 50% to 25%.
  - Further Reduction for Timely Correction: Down to 10% if corrected within two years.
- **Tax Obligations**: In addition to the penalty, you are still required to withdraw the missed amount and pay any ordinary income tax due on the distribution.
- **Correction Procedures**: If you miss an RMD, you can correct the oversight by immediately taking the required distribution and filing IRS Form 5329 with your tax return. You can also attach a letter explaining the reasonable error and outlining corrective actions taken. In some cases, the IRS may waive the penalty.

Tax Considerations

- **Ordinary Income**: RMDs are taxed as ordinary income at your current tax rate. Therefore, timing your withdrawals to align with years of lower income can reduce the amount of taxes owed.
- **Withholding Taxes**: You can choose to have taxes withheld from your RMDs automatically, like a paycheck, to avoid underpayment penalties. Note, you must make arrangements ahead of your initial draw date to avoid any tax penalties.

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- **Charitable Contributions**: If you are 70½ or older, you can transfer up to $100,000 per year directly from your IRA to a qualified charity. This move can satisfy your RMD requirement without the distribution being added to your taxable income.

Strategies for Managing Distributions

- **Multiple Accounts**: If you have several retirement accounts, you must calculate the RMD for each account separately but can withdraw the total amount from one or a combination of those accounts. This flexibility allows you to strategically choose from which accounts to withdraw based on their investment performance or tax implications.
- **Consolidation**: Consolidating multiple retirement accounts into fewer ones can simplify RMD management and tracking.
- **Timing**: Consider taking RMDs late in the year if you expect your taxable income to be lower than usual. Conversely, if you anticipate higher taxable income in future years, taking distributions earlier may be beneficial.
- **Investment Considerations**: Manage your investments based on the knowledge that you will be withdrawing funds annually. This might mean adjusting your investment strategy to focus on generating income or preserving capital as you approach the age for taking RMDs.

Planning for Non-Traditional Situations

- **Still Working Exception**: If you're still working at age 72 and don't own more than 5% of the company, you can delay RMDs from your current employer's 401(k) until retirement. This does not apply to IRAs or 401(k) plans from previous employers.
- **Roth Conversions**: Converting traditional IRA funds to a Roth IRA can be a strategic move to reduce future RMDs, as Roth IRAs do not require RMDs during the owner's lifetime. This strategy requires paying income tax on the converted amount but can result in tax-free growth and withdrawals later on.

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