

# REQUIRED MINIMUM DISTRIBUTIONS: HOW ARE THEY CALCULATED?



Required Minimum Distributions, commonly referred to as RMDs, are the government's way of collecting the taxes they have allowed workers to defer. Prior to reaching age 70 ½, the government allows workers to save a portion of their pre-tax earnings, incentivizing retirement contributions.

Tax laws surrounding RMDs can be confusing. The IRS ensures retirees withdraw at least a portion of the funds in their retirement account over their lifetime, and that taxes are paid on those funds. Tax laws require owners of certain qualified investments, such as 401(k)s, traditional IRAs, qualified annuities and other employer provided qualified plans, to take RMDs after turning age 70 ½. RMDs are calculated by dividing the prior year-end fair market value of the retirement assets by the applicable distribution period, also known as the RMD Factor.

**Calculation Example:** A retiree is 75 years old with IRA assets \$1,000,000 as of December 31<sup>st</sup>, 2016. During 2017, the client is required to take \$43,700 ( $\$1,000,000 / 22.9$ , see table) in RMDs from their traditional IRA holdings to meet the required minimum distribution. The retiree must make this RMD by December 31<sup>st</sup>, 2017.

If an individual fails to comply with RMD rules, the IRS will impose a 50% penalty in addition to withholding the taxes that would have been due from the distribution. Taking the time to understand these rules is essential for projecting your retirement income strategy.

**Required Beginning Date (RBD):** The RBD is the latest date that a retiree can wait to claim their first RMD. For qualified assets, the Required Beginning Date is April 1<sup>st</sup> of the year after the individual reaches 70 ½. There are two basic options to consider when you turn 70 ½:

**Option 1 – Take one RMD:** During 2017, the retiree turns 70 ½ with qualified assets of \$1,000,000 as of year end 2016. The retiree takes their first RMD of \$36,496 ( $\$1,000,000 / 27.4$ , see table) from his/her qualified retirement balances.

**Option 2 – Delay and take two RMDs:** During 2017, the retiree turns 70 ½ with qualified assets of \$1,000,000 as of year-end 2016. The retiree wants to wait until the latest possible time to take their first RMD. In 2018, (the following year after the retiree reaches 70 ½) the retiree is required to take the RMD for both 2017 and 2018. Assuming their qualified assets grew to \$1,100,000 at year-end 2017, their total RMD in 2018 would be:

$(\$1,000,000 / 27.4, \text{ see table}) = \$36,496$  (taken by April 1<sup>st</sup>, 2018)

$(\$1,100,000 / 26.5, \text{ see table}) = \$41,509$  (taken by December 31<sup>st</sup>, 2018)

This means that in 2018 the retiree would incur taxation on two RMDs in one year, potentially increasing their tax bracket. In most cases, it's better for the retiree to claim their first RMD in the year they turn 70 ½.

Age	RMD Factor	RMD Percentage
70	27.4	3.65%
71	26.5	3.77%
72	25.6	3.91%
73	24.7	4.05%
74	23.8	4.20%
75	22.9	4.37%
76	22	4.55%
77	21.2	4.72%
78	20.3	4.93%
79	19.5	5.13%
80	18.7	5.35%
81	17.9	5.59%
82	17.1	5.85%
83	16.3	6.13%
84	15.5	6.45%
85	14.8	6.76%
86	14.1	7.09%
87	13.4	7.46%
88	12.7	7.87%
89	12	8.33%
90	11.4	8.77%
91	10.8	9.26%
92	10.2	9.80%
93	9.6	10.42%
94	9.1	10.99%
95	8.6	11.63%

For more details on IRA distribution rules please see IRS circular 230

# REQUIRED MINIMUM DISTRIBUTIONS: WHAT ARE YOUR OPTIONS?

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Many individuals find themselves in a position where they do not need to withdraw from these accounts after 70 ½. For those looking for creative ways to avoid paying tax on their RMDs, below are some options to consider:

- **KEEP WORKING**

If you are working past 70 ½, you will not be required to take RMDs from your current employer's qualified plan. IRAs - including SEP and SIMPLE IRAs - as well as previous employer plans, will still require withdrawals to satisfy their RMDs after 70 ½. If your plan document allows, you may roll over IRAs and previous qualified plans into your existing employer plan to prevent all RMDs.

Exception: If you own more than 5% of the company that sponsors the qualified plan, you will still be required to take RMDs from the account. This can potentially affect many business owners – such as lawyers, doctors and other professionals who practice past 70 ½.

- **QUALIFIED CHARITABLE DISTRIBUTION (QCD)**

If you are at least 70 ½, the QCD rules allow you to distribute up to \$100,000 of your RMD to a qualified charitable organization. The amount given to the charity is not taxable to you. You will no longer be able to use that donation as an itemized deduction, but you can still claim a standard deduction. Any donation above your RMD will not be eligible to offset RMDs in future years.

To successfully make a Qualified Charitable Distribution, the distribution check must be made payable directly to the charitable entity. The Custodian of the IRA will be able to write the check directly to your charity. QCDs are an ideal way to lower your tax liability and fulfill your charitable intentions at the same time.

- **ROTH IRA CONVERSIONS: START EARLY**

IRS rules prohibit you from taking a RMD and reinvesting it into a Roth IRA. To contribute to a Roth IRA, you must either have earned income below the limits, or convert your traditional IRA to a Roth IRA. Although you will pay taxes in the year you convert the account into a Roth IRA, all future appreciation and income will not be subject to RMDs or taxation. There is no annual limit on how much you can convert.

To best take advantage of a Roth conversion, it's better to start converting before 70 ½. If you wait until you are over age 70 ½ to convert, you will still need to take the RMD in the year you convert. Making small conversions each year leading up to 70 ½ will reduce your RMD liability, and increase your Roth assets that you can later withdraw tax-free.

- **QUALIFIED LONGEVITY ANNUITY CONTRACT (QLAC)**

QLACs are deferred annuities that provide lifetime income and lower your current RMDs. These are especially beneficial for individuals who are concerned about outliving their retirement assets, but have no need for their RMDs early in retirement. A QLAC allows you to defer your retirement assets up until age 85, and then provide a lifetime income stream (either single or joint). The IRS currently restricts a QLAC purchase to the lesser of \$130,000 or 25% of your aggregate IRA account values.

For more information on QLACs, see our piece titled "Qualified Longevity Annuity Contract" in the RISK section of ValMark Processes.