Who’s Afraid of the Big, Bad RMD?

As many of us near retirement age, we start to notice articles and advertisements regarding Required Minimum Distributions, also called “RMDs.” Often, these pieces are written and promoted by people in the financial profession who want to persuade you to use their services. Some ads seem designed to scare the reader into believing that a maze of penalties and tax blunders awaits those who enter into the intimidating world of RMDs. I’d like to take a moment to still the waters. In most instances, RMDs are not a big, bad problem. Let’s address some frequently asked questions.

What in the world is an RMD?

A Required Minimum Distribution is an amount you must distribute every year from your traditional IRA and most other retirement accounts, usually starting in the year you turn 70 ½. Why is it required? When you put money into your retirement account, you made a deal with the IRS. Now, this is a good deal for you. (Actually, it’s so good the government keeps talking about changing it.) In short, the IRS lets you deduct your retirement account contributions from your income throughout your working years. They also let your retirement accounts grow without requiring any taxes to be paid. In exchange, when you start to take withdrawals, you must pay ordinary income taxes on the amount you take out. By the time you reach the age of 70 ½, the IRS wants to make sure that you start to pay some taxes; so you are required to take at least a certain percentage from your account every year.

How is your RMD calculated?

For most retirement accounts, your RMD is calculated using the value of your account at the end of the previous year and your life expectancy. For most of the retirement accounts we manage, your custodian does this math for you (TD Ameritrade and Charles Schwab do this in January). You can request this information from them directly. For accounts that we manage, you can call us since the custodians provide this to us as well. We’ll also help you get these minimum distributions completed if you’d like.
Just how big are these RMDs anyway?

The first year, your RMD is usually a little less than 4% of the value of your retirement portfolios. As you get older, the percentage goes higher, but even at age 90, the RMD is usually less than 9% of these account balances. The point is, these distributions are not that large in percentage terms.

When do I need to start taking my RMD?

As noted above, 70 ½ is the “magic” age when most RMDs begin. Normally you need to take your RMD by December 31st each year. For your first distribution, the IRS gives you until April 1st of the following year. But typically we don’t advise waiting past the normal deadline. If you wait, you’ll need to remember to take two distributions in that calendar year (and pay the taxes for both).

Is there a penalty for missing my RMD?

Yes there is, and it’s not pretty. You still have to take the RMD, even if it’s late. But in addition to the tax you owe on the distribution, the IRS assesses a penalty of 50% of the RMD amount. We keep a list of the retirement accounts we manage and remind our clients about these RMDs every year.

How do I take my RMD?

For the retirement accounts we manage for you, we’ll work with you and the custodian to help you complete your RMD and let you know when it’s done. Some like to have equal monthly amounts sent to their checking account while others want the lump sum at the end of the year. You can elect to have taxes withheld from each distribution, which should make tax time less painful.

For accounts we don’t manage, we won’t know what you’re required to take or whether you’ve already satisfied your RMD requirements. It is important to work with your tax advisor, let your custodians know your instructions, and make sure they are followed.
I don’t need the money from the RMD. Can I put it back in?

While you can’t put the distribution back into your retirement account, many of our clients who don’t need the money move their RMD into their regular investment account.

I need more money than the RMD calls for. Is that allowed?

Yes, it is. An RMD is the minimum amount you must take from your retirement account after you turn 70 ½. You can always take out more, without penalty, as long as you are older than 59 ½. Just remember that you will also need to pay ordinary income taxes on these withdrawals.

Should I take money out of my IRA now in order to reduce my future RMDs?

That’s probably not a good idea. Remember that when you take money from your traditional IRA, you’ll owe ordinary income taxes on the full amount of the distribution. (If you're under the age of 59 ½, a 10% penalty may also be applied.) So, you are just prepaying taxes today on what will be due in the future. You will also lose any advantage of having this amount grow in a tax-deferred account. You should also be aware that if you take a large enough distribution, you may move to a higher tax bracket, thus causing you to pay higher taxes than you might in the future.

I’m in my 60’s. Should I just convert my traditional retirement accounts into a Roth IRA?

At your age, probably not. Roth IRAs are attractive because distributions are not taxable and there are no RMDs (unless you inherited the Roth from someone besides your spouse).

However, Roth IRA contributions are not tax deductible. Accordingly, any amount you convert from a traditional IRA to a Roth is taxed as ordinary income in that year. This may move you into a higher tax bracket than you are in now (or perhaps ever will be again). In return for “never paying taxes again” on distributions, you may be prepaying your taxes today at a higher rate. In addition, if you don’t have the money outside of your IRA to pay these taxes, you’re also reducing the size of your retirement portfolio. That’s not a good combination. Furthermore, the IRS will make you wait five years after any conversion before withdrawing money or you will be hit with a 10% penalty.
There may be a particular set of circumstances where this makes sense, so consult a tax professional that knows your situation. But for most people approaching retirement age, we’re concerned these conversions do more harm than good.

**Getting back to the point...**

Fear sells. In some cases, like promoting seat belt usage or warning about the dangers of illicit drugs, that can be a good thing. But when fear of paying taxes is used to entice people to follow strategies that will most likely end up reducing their wealth—well, that’s not so good. While it’s always important to get individualized advice from a tax expert, in most instances, RMDs are not a big, bad problem.

*This advice is general in nature and is not intended as a substitute for discussing your specific situation. Please call us and we will set up a time to examine yours.*

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**Eric Ball, CFA®**  
Chief Executive Officer  
America First Investment Advisors, LLC