Required Minimum Distribution Tips and Traps

By Christine Benz | 12-15-11 |

The tax-deferred compounding you get via an IRA or a company retirement plan enables you to grow your savings without having to fork over taxes on your investment earnings year in and year out. However, at some point, the Internal Revenue Service says, "Enough is enough; it's time for us to take a cut." This is when required minimum distributions, or RMDs, take effect.

All retirees must begin taking RMDs from their traditional, SEP, and SIMPLE IRAs, as well as 401(k), 403(b), and 457 plans, by April 1 of the year following the year in which they turn age 70 1/2. (Got that?) They must then continue to take distributions by Dec. 31 of each year thereafter. Roth IRAs aren't subject to RMDs--after all, the IRS has already gotten its cut--but oddly, Roth 401(k)s are.

The amount you withdraw from your accounts is formulaic: You look back to the balances you held in your IRAs and other retirement accounts at the end of the previous year, then divide it by a factor based on your life expectancy and that of your beneficiary, if applicable. (You must consider your balances within different account types separately--for example, you'd calculate your RMD amount for your IRA, then move on to calculating your RMD amount for your 401(k).) The IRS' website includes some worksheets for calculating your RMDs, but online calculators also abound, such as this one from FINRA.

However, you exert more control than you might think over the timing of your RMDs, as well as which accounts you tap. Here are some tips for getting the most out of your RMDs as well as some traps to avoid.

Do

Be surgical about which accounts from which you draw your assets. Even though you must calculate your RMD amounts for each of your traditional IRAs, for example, you can draw your RMD from the investment that's most advantageous for you. For example, if you've assessed your asset allocation and determined it's time to rebalance, take your RMDs from the IRAs that hold assets where you need to lighten up. (For most rebalancers in 2011, long-term bonds will be a likely area on which to scale back.)

- Rather than taking your whole distribution at year-end in a lump sum, consider spacing your distributions throughout the calendar year to obtain a range of purchase prices for your longer-term assets.
- Consider "bucketing" your IRA and retirement-plan assets. That means maintaining assets in cash or cashlike accounts to help address RMD and other income needs, intermediate-term assets (such as bonds) that are next in line for distributions, and long-term assets.
- Put your distributions on autopilot to avoid the last-minute rush to execute trades (or worse, to avoid missing the deadline altogether). If you go the autopilot route, be sure to maintain cash assets in your accounts to avoid having your fund company or brokerage firm sell a long-term asset that you would have preferred to hold.

- Coach elderly parents on taking their RMDs, even if you're not required to take them yourself.

Don't

- Miss the deadline. You'll owe a tax penalty equal to the distribution amount you should have taken but didn't as well as the taxes that are due on any retirement-plan distribution.
- Pay a tax penalty without stating your case first. The IRS' website indicates that the penalty will be waived if "the shortfall in distributions was due to reasonable error and that reasonable steps are being taken to remedy the shortfall." So if you've missed a distribution or didn't take as much of an RMD as you should have, you'll need to fill out IRS form 5329. You'll also have to submit a letter detailing why you had a shortfall in your distribution and what you're doing to remedy it. (A tax professional can also help coach you through this process.)
- Consider your RMDs "mad money" unless you've analyzed your retirement plan's viability and determined that you can afford to splurge.
- Plow the proceeds into a Roth IRA without doing your homework first. You need to have enough earned income--generally, that means income from a job--to cover the amount of your IRA contribution. (For example, if you want to contribute $6,000 to a Roth, you'd need to have at least $6,000 in earned income to do so.) Unfortunately, income drawn from your retirement accounts doesn't count. Note that you can't make additional traditional IRA contributions after age 70-1/2.