



A Comprehensive Guide To Lifetime Required Minimum Distributions

Executive Summary

- The fundamental benefit of a traditional pre-tax retirement account is the opportunity to enjoy tax-deferred growth. Which for long-term retirement accumulations, can stretch for decades. Ultimately, the expectation is that retirees will take withdrawals from the retirement account to satisfy their retirement spending needs. But if withdrawals aren't happening, eventually the government will *require* that a minimum amount of distributions begin (and become taxed), under the so-called "Required Minimum Distribution" (RMD) rules.

- The obligation to take required minimum distributions begins once the retirement account owner reaches age 70 ½, with the first distribution due by April 1st of the following year, although an exception applies to further delay RMDs from an employer retirement plan if the employee is still working for that employer (and is not a more-than-5% owner). In addition, there are no RMD obligations for Roth IRAs during life.

- The RMD is calculated as a fraction, where the numerator is the value of the account at the end of the prior year, and the denominator is the joint life expectancy of the account owner and a (hypothetical) beneficiary who is 10 years younger. All retirement account owners use these life expectancy factors – known as the Uniform Life table – except in the case of a spouse as sole beneficiary, who is more than 10 years younger, in which case the RMDs are calculated based on the actual joint life expectancy of the account owner and his/her spouse.

About the Author

Michael E. Kitces, MSFS, MTAX, CFP®, CLU, ChFC, RHU, REBC, CASL, is a Partner and the Director of Wealth Management for private wealth management firm Pinnacle Advisory Group (www.pinnacleadvisory.com), located in Columbia, Maryland. In addition, he is an active speaker, and publishes *The Kitces Report* and his blog "Nerd's Eye View" at his website www.kitces.com.

- Each retirement account has its own RMD obligation, which must be taken from that account. However, the RMD aggregation rule allows all RMDs specifically attributable to an individual's IRAs to be taken from *any* of those IRAs.

- The consequences for missing an RMD are severe, with a penalty of 50% of the shortfall amount, but the IRS can (and often does) grant waivers of the penalty if there is a reasonable cause for the failure to take the RMD, it is promptly corrected once discovered, and the mistake is reported (with a letter of explanation to request the waiver) on Form 5329.

- For those who are charitably inclined, a direct distribution from an IRA to a charity can be treated as a "qualified charitable distribution" (QCD), which is both a non-taxable distribution, *and* satisfies the individual's RMD obligation for the year. Notably, QCDs are only available to those who are above age 70 ½ (which means there *will* be an RMD to satisfy!), can only be done from an IRA, must be made to a public charity, and are limited to no more than \$100,000/year.

- When an annuity with substantial living or death benefit guarantees is held inside of an IRA, the actuarial value of the guarantees must be considered when determining the "value" of the account for RMD purposes.

- An immediate annuity purchased with retirement account dollars is automatically deemed to satisfy its own RMD obligation. And since 2012, the IRS and Treasury even permit retirement account owners to purchase an annuity where the payments will not begin until age 85 – effectively allowing extra years of tax deferral – as long as the annuity meets the so-called "Qualified Longevity Annuity Contract" (QLAC) requirements. Though notably, it's still not necessarily a good deal to use a QLAC just to defer RMDs.

- Ultimately, while it's always desirable to minimize and defer taxation to the extent possible, it's important to recognize that a pre-tax IRA *will* be taxed eventually. Which means managing RMDs doesn't avoid taxation, although it can provide at least some tax deferral value!

Introduction

One of the key benefits of retirement accounts, whether in the form of a traditional IRA or an employer retirement plan like a 401(k), is that growth in the account is tax deferred. Unlike “regular” taxable accounts, where income (i.e., interest and dividends) is taxed annually, and capital gains are taxed upon sale, a traditional retirement account is not taxable until funds are actually withdrawn from the account. Or, in the case of a Roth style account (IRA or 401(k)), the withdrawals may not be taxable at all (if eligible for “qualified distribution” treatment).

The caveat to providing favorable tax treatment for retirement accounts is that ultimately, the Federal government *will* get its share of the growth. And to ensure this outcome, the Internal Revenue Code requires that eventually, upon reaching a certain age, owners of traditional pre-tax (but not necessarily Roth-style) retirement accounts *must* begin to take withdrawals from the account – even if they don’t otherwise need the money – and face the tax consequences. The age at which the government says “enough tax deferral!” is 70 ½. And the rules that begin to force money out of the account are called “required minimum distributions” (or “RMDs” for short, and sometimes also known as an MRD instead, based on the IRC Section 4974 penalty for failing to take sufficient “Minimum Required Distributions”).

In this month’s newsletter, we explore the rules for required minimum distributions during the lifetime of a retirement account owner, including how to calculate the RMD, the timing rules for completing the RMD, how to coordinate RMDs with charitable distributions and immediate or longevity annuities, and special valuation rules and issues that can arise when trying to determine the RMD account balance with illiquid investments, annuities with substantial living or death benefit guarantees, or simply bonds with accrued (but unpaid) interest.

Proactively managing RMDs – to the extent possible – is appealing in a world where no one likes paying taxes any sooner than have to. Though given the potential 50%(!) penalty tax for failing to complete a required minimum distribution, often the most important part of “planning” for RMDs is simply ensuring that they actually happen in the first place, and in a timely manner!

Required Minimum Distributions During Life

The basic concept of the RMD is relatively straightforward. Upon reaching the specified age, the retirement account owner must take a distribution from the account each year. Because the purpose of the rules is to force the money out of the account, but not necessarily to deplete it at a too-rapid pace (for those who actually *need* to use the money for retirement spending), the required amount is determined based on the age of the account owner, such that the account “will be distributed... over the life of the [retirement account owner] or the lives of the [retirement account owner] and a designated beneficiary” under IRC Section 401(a)(9)(A)(ii).

In practice, those who are *already* using their retirement accounts to sustain their retirement lifestyle may *already* be withdrawing more than enough to satisfy the RMD obligation. Nonetheless, for those who are not actually taking large enough withdrawals from the retirement account, the Required Minimum Distribution, by definition, specifies the minimum required amount that *must* be taken out, to draw the account down over the remaining life of the account owner. Of course, because it’s only a *minimum*, it’s always permissible to take out more.

When Must RMDs Begin?

The first “distribution year” for a required minimum distribution is the year that the retirement account owner turns age 70 ½.

Notably, the timing of reaching age 70 ½ is defined very specifically under Treasury Regulation 1.401(a)(9)-2, Q&A-3: age 70 ½ is attained precisely 6 months after the individual’s 70th birthday, regardless of how many days are in the month.

Thus, for someone who was born on March 23rd of 1947, he/she turns age 70 on March 23rd of 2017, and turns 70 ½ on September 23rd of 2017. Which means someone born on July 1st of 1947 will turn 70 ½ *next year* on January 1st of 2018 (and more generally, anyone with a birthday of July 1st or later in a given year will not reach the 70 ½ threshold until the following year).

In the event that the individual is still working (for the *entire* year), the first distribution for the RMD *from that*

employer's retirement plan is delayed until the year he/she actually retires. However, this delayed-RMD rule applies only to that particular employer retirement plan – not other employer retirement plans, nor to any IRAs. And it only applies if the employee does *not* own more than 5% of the business (including shares of the business owned by parents, a spouse, children, grandchildren, or ownership attributable from trusts or related business).

In other words, if the individual is still working and does *not* own more than 5% of the business – e.g., is a “rank and file” employee or has only a small minority stake – the first RMD year for that employer’s retirement plan is delayed until the employee retires. If more than 5% of the business *is* owned, then the standard age 70 ½ rule applies. In addition, under Treasury Regulation 1.401(a)(9)-2, Q&A-2(e), qualified plans have the *option* of requiring the first distribution year to be the year the employee turns age 70 ½, regardless of whether the employee is still working; if this is the case, the Summary Plan Description should specify accordingly.

Either way, this rule to delay the onset of RMDs only applies to employer retirement plans, and specifically to that *particular* business’ employer retirement plan. Any other employer retirement plans, along with any IRAs, will still be subject to the standard age 70 ½ rule for determining the first required minimum distribution year, regardless of employment status. And any more-than-5% owner will always have to begin RMDs from any/all accounts upon reaching age 70 ½.

Example 1. Andrew turned age 70 in February, and thus will also turn age 70 ½ this year (in August), making this his first distribution year for RMD purposes. Andrew has three accounts – an individual IRA, a 401(k) plan from his former employer (where he did not own any shares in the business), and an individual 401(k) associated with his Schedule C consulting business (in which he is still actively working).

In this situation, Andrew will be required to begin distributions from all three accounts. With respect to the IRA, RMDs must begin because Andrew has reached age 70 ½. In the case of the (former employer’s) 401(k) plan, RMDs must also begin this year, as while Andrew may still be working, he’s no longer working for *that* employer, which means even though he was/is not a more-than-5% owner, he must still begin RMDs at age 70 ½ and isn’t eligible for the delayed-RMD rule. And

Andrew will also be required to begin RMDs from the individual 401(k), as while he *is* still working for that “employer”, as a self-employed consultant filing a Schedule C, he is by definition a 100% “owner” of the business, and therefore is a more-than-5% owner and ineligible to delay RMDs.

RMD Obligations For Roth-Style Accounts

Because the primary purpose of required minimum distributions is to ensure that Uncle Sam gets his share of a pre-tax retirement account, required minimum distributions generally only apply to *pre-tax* retirement accounts in the first place. In other words, accounts where distributions will be fully taxable – like traditional IRAs and 401(k) plans – are subject to RMDs upon reaching the specified age. By contrast, Roth IRAs are *not* subject to required minimum distributions during the life of the account owner. Since the Roth-style distribution would have been tax-free anyway.

Notably, though, the ability to avoid RMDs with Roth IRAs applies only to the IRA version of the account. In the case of a Roth 401(k) (or a Roth 403(b)) plan, required minimum distributions *will* still apply upon reaching age 70 ½ (or later in certain circumstances of still-working employees). The reasoning is that while a Roth 401(k) distribution may be tax-free, to simplify the administration of employer retirement plans, the tax code specifies that even Roth-style employer retirement plans must still comply with the same RMD obligations as their pre-tax counterparts. However, if a Roth 401(k) or Roth 403(b) account is rolled *into* a Roth IRA, any subsequent lifetime RMDs will no longer apply, per the standard rules for Roth IRAs.

It’s also important to note that while Roth IRAs have no required minimum distribution obligations during the lifetime of the account owner, *after death* Roth IRAs still have the same post-death RMD obligations as any other type of retirement account, including the option to stretch out required minimum distributions over the life expectancy of the beneficiary, or, in certain circumstances, be subject to the 5-year rule. While the tax treatment of a post-death RMD may still differ – where the RMD from a traditional retirement account is taxable, while from a Roth IRA it is tax-free – the obligation to take money out of the account (and have it be subject to *future* taxation thereafter) remains the same.

Nonetheless, the key point remains: Roth IRAs *are* able to avoid required minimum distributions during the lifetime of the IRA owner, but *only* while he/she is actually alive!

How The RMD Is Calculated

The annual RMD obligation is a certain *percentage* of the retirement account(s) that must be withdrawn each year. As noted earlier, the percentage itself varies based on the age (and life expectancy) of the retirement account owner. Which means in practice the RMD is calculated as a fraction, where the numerator is the account balance, and the denominator is life expectancy based on the age of the retirement account owner, as shown in Figure 1 (below).

However, because the tax code specifies that RMDs must occur “over the life of the retirement account owner, or the lives of the account owner and his/her designated beneficiary”, in reality, Treasury Regulation 1.401(a)(9)-5 specifies that the account must be distributed not simply over “life expectancy” but over an “applicable distribution period” that considers the prospective life expectancy of *both* the account owner and the beneficiary.

Determining The Applicable Distribution Period

Historically, the applicable distribution period was determined based on the actual joint life expectancy of the retirement account owner, and the beneficiary associated with that retirement account.

However, this created substantial complications in practice. Retirement account owners could obtain lower RMD obligations by increasing the denominator of the RMD calculation through the deliberate selection of beneficiaries who were younger and had longer life expectancies (e.g., by choosing children or grandchildren as beneficiaries, instead of a spouse). Yet this also meant that if the retirement account owner unexpectedly passed away, the account would actually *go* to those beneficiaries, potentially disinheriting the originally intended (e.g., spousal)

beneficiary. But naming the intended beneficiary – particularly a surviving spouse – meant naming an *older* beneficiary (than a child or grandchild), with a shorter life expectancy, causing *higher* required minimum distributions during life! The end result was an awkward series of trade-off decisions.

To address these challenges, in 2002 the Treasury issued updated regulations (which first took effect in 2003), drastically simplifying the RMD calculation process. Instead of using the actual joint life expectancy of the retirement account owner and his/her beneficiary (which would vary depending on which beneficiary was named on the account), the rules instead stipulated that the RMD would simply be based on the joint life expectancy of the retirement account owner and a hypothetical beneficiary who is 10 years younger. Thus, the required distribution for a 71-year-old would be based on the joint life expectancy of a 71-year-old and a 61-year-old. An RMD for a 77-year-old would be based on the joint life expectancy of a 77-year-old and a 67-year-old. Etc. Regardless of the *actual* age of the named beneficiary.

These Applicable Distribution Periods – based on the joint life expectancy of the account owner and a 10-years-younger beneficiary – were then codified in what is now known as the “Uniform Life Table” (uniform, because it applies to all retirement account owners regardless of who the actual beneficiary is), available in Table III of Appendix B of IRS Publication 590 (and shown in Figure 2, top of next page).

RMDs When The Spouse Is Sole Beneficiary

The only exception to the standard rule of using the Uniform Life Table, under Treasury Regulation 1.401(a)(9)-4, Q&A-4(b), is that in situations where a spouse is the *sole beneficiary* of the retirement account, *and* the spouse is *more than 10 years younger* than the account owner, the RMD may be calculated using the *actual* joint life expectancy of the account owner and

Figure 1. Formula For Calculating RMDs

$$\text{RMD} = \frac{\text{Account Balance}}{\text{Applicable Distribution Period}}$$

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Figure 2. Uniform Life Table For Calculating Lifetime Required Minimum Distributions

Uniform Life Table for Calculating Lifetime Required Minimum Distributions					
Age	Divisor	Age	Divisor	Age	Divisor
70	27.4	85	14.8	100	6.3
71	26.5	86	14.1	101	5.9
72	25.6	87	13.4	102	5.5
73	24.7	88	12.7	103	5.2
74	23.8	89	12	104	4.9
75	22.9	90	11.4	105	4.5
76	22	91	10.8	106	4.2
77	21.2	92	10.2	107	3.9
78	20.3	93	9.6	108	3.7
79	19.5	94	9.1	109	3.4
80	18.7	95	8.6	110	3.1
81	17.9	96	8.1	111	2.9
82	17.1	97	7.6	112	2.6
83	16.3	98	7.1	113	2.4
84	15.5	99	6.7	114	2.1
				115+	1.9

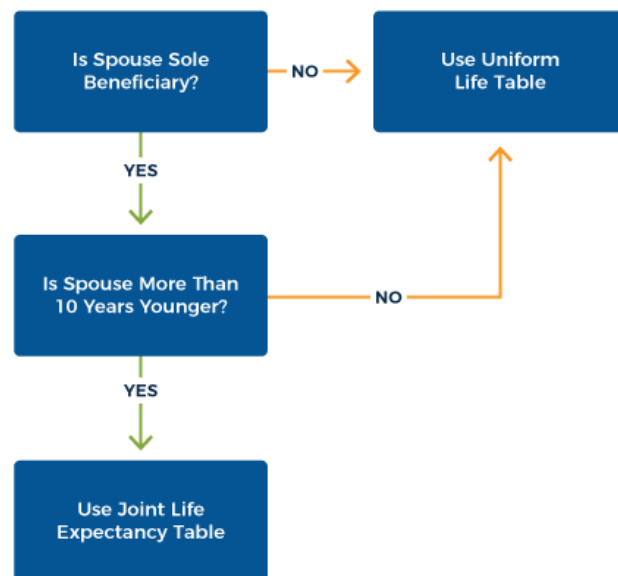
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his/her spouse (with the appropriate age-specific joint life expectancy tables provided in Table II of Appendix B of IRS Publication 590).

In order for the spouse to be treated as the sole beneficiary of the retirement account, he/she must be the sole beneficiary for the *entire* calendar year. (However, in the event of a change in marital status, Treasury Regulation 1.401(a)(9)-5, Q&A-4(b)(2) stipulates that as long as the retirement account owner was married on January 1st of that year, the spouse can be treated as the [sole] beneficiary, even if the couple divorced or the spouse died later in that year.)

In situations where there is a sole spouse as beneficiary who is more-than-10-years younger, it will always be advantageous to use the joint life expectancy table. As the joint life expectancy with a more-than-10-years-younger spouse will be even longer than the Uniform Life table, which increases the denominator of the RMD calculation and results in a smaller RMD obligation.

Figure 3. Determining Which Life Expectancy Table To Use For Lifetime RMDs



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Thus, ultimately, the applicable distribution period will either be the Uniform Life table (the joint life expectancy of the account owner and a hypothetical beneficiary who is more than 10 years younger), or the Joint Life table with the actual joint life expectancy of the account owner and his/her spouse, if the spouse is the sole beneficiary *and* more than 10 years younger, as shown in Figure 3.



Planning Tip: Because RMDs in most cases are calculated using the Uniform Life table, the RMD obligation will be the same regardless of whether multiple retirement accounts (with varying beneficiaries) are merged together or held separately. However, in situations where there is a spouse who is more than 10 years younger, any retirement accounts for his/her benefit should be held separately, such that the spouse can be named the sole beneficiary of that account, and obtain the more favorable RMD treatment for that account.

Determining The Correct Age To Use For RMD Calculations

When determining the correct “age” to use in referencing the life expectancy tables, the calculation should be based on the age of the individual at the *end* of the current distribution year – i.e., how old he/she will turn *on* his/her birthday this year.

Example 2. Ashley is currently age 72, and will turn 73 in November. As a result, Ashley’s RMD for the current year will be based on her age 73, even though he/she is 72 for “most” of the year. In fact, even if Ashley *takes* her RMD early in the year – when she’s still actually age 72 – her RMD will still be calculated using age 73, based on how old she *will* be on her birthday (and at the end of the year).

In the case of a more-than-10-years-younger sole spouse beneficiary, the age of the spouse for the purposes of the joint life expectancy table is also determined as of the end of the *current* year (i.e., again based on the age he/she will attain *on* his/her birthday in the current year).

Notably, for the first RMD – due for the year in which the individual turns age 70 ½ – the first applicable distribution period may be based on *either* age 70, or age 71, depending on when

the individual’s birthday falls during the year. Those whose birthdays fall in the first half of the year will calculate their first RMD based on age 70, as they will not yet have turned age 71 by the end of the year. However, those whose 70th birthdays fall in the second half of the year will not turn 70 ½ until *next* year, which is also the year they turn age 71; as a result, those individuals will never actually take an RMD based on being age 70, as their very first RMD will already use the age 71 life expectancy factor.

Example 3. Neil was born on August 22nd of 1937, and has a \$150,000 IRA where his son Jonathan is the beneficiary. As a result, Neil turns 70 on August 22nd of 2017, which means he will turn age 70 ½ on February 22nd of 2018, and 2018 will be his first required minimum distribution year. Given that 2018 is Neil’s first distribution year, and he will turn 71 that year (on August 22nd), his first RMD will be based on the age 71 life expectancy factor in the Uniform Lifetime Table. As a result, Neil will divide his 12/31/2017 account balance by 26.5 to determine his first RMD for 2018, and he will never actually use the age-70 applicable distribution period of 27.4.

Determining The “Value” Of The Retirement Account

To calculate a required minimum distribution, it’s necessary to divide the value of the account by the applicable distribution period. In most cases, the “complexity” of an RMD is determining the right applicable distribution period, using the appropriate life expectancy table. In some cases, though, determining the account value presents challenges as well.

The standard rule under Treasury Regulation 1.401(a)(9)-5, Q&A-3, is that the account is valued based on “the account balance” at the end of the *prior* calendar year. Thus, for instance, if the individual’s first required minimum distribution is due for the 2017 calendar year, the valuation date is December 31st of 2016.

For most investments, this approach to determining the account balance is relatively straightforward, and simply involves either obtaining a prior-year 12/31 statement (showing the account balance), or reporting the account balance obtained from the advisor’s portfolio accounting and performance reporting engine.

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However, additional complexities arise in the case of illiquid securities, which in the extreme may require obtaining a standalone valuation to determine the RMD (particularly in the case of self-directed IRAs directly holding illiquid assets). The fact that an asset may be hard-to-value doesn't excuse the requirement that it must carry *some* reasonable value.

Another complexity that arises in determining the "value" to use for RMD purposes is in the case of substantial bond holdings, which may have accrued interest, and particularly directly-held TIPS bonds, which also periodically accrue a principal adjustment for inflation. Unfortunately, the Internal Revenue Code and Treasury Regulations themselves are actually silent on the issue of whether/how accrued bond interest (or periodic TIPS principal inflation adjustments) should be considered for the purposes of determining the "account balance" of a retirement account for RMD calculation purposes.

Notably, though, the plain reading of Treasury Regulation 1.401(a)(9)-5, Q&A-3 itself, states that the amount used to determine the RMD is the "account balance", and does not explicitly stipulate that the "fair market value" must be used, as is required for other valuation purposes (e.g., the value for gift or estate tax reporting). Of course, even an "account balance" must still itself be valued, but Treasury Regulation 1.1471-5(b)(4) states that "the balance or value of a financial account is the balance or value calculated by the financial institution for purposes of reporting to the account holder." In other words, whatever the standard practice is for the financial institution in reporting the "value" of the assets held in the account (and whether the institution reports accrued bond interest as part of the valuation) really does become the "proper" valuation to be used for RMD reporting purposes.

Nonetheless, given that the going price of a bond in the open market really *does* reflect the amount of its associated accrued interest, most advisors err to the side of caution and calculate all required minimum distributions *including* accrued bond interest. And in point of fact, many financial institutions typical report the value of the account include bond interest anyway.

Fortunately, in practice the difference is often not very material, particularly in today's low-interest-rate environment. Even a \$100,000 bond paying a 1.5% coupon twice a year (for a 3% annual yield), with a payment date that happens to fall just after New Year's (such that the 12/31 value would include virtually all of the prior 6 months' worth of accrued

interest), would only have to increase the first RMD by \$54 to account for the accrued interest.



Planning Tip: It is reasonable to rely on the "account balance" as reported by the financial institution to determine the end-of-year prior account balance for calculating an RMD (regardless of whether the institution actually includes the value of accrued bond interest). Nonetheless, for those who wish to err to the side of caution, a conservative best practice is to include all accrued bond interest (even if it wasn't already reported in the account balance), as the reality is that if a trade had actually been executed that day, the "value" of the bond in the account would have clearly included the value of the accrued interest associated with the bond.

Adjusting The RMD Account Balance For (Subsequent) Rollovers And Recharacterizations

In most cases, determining the account balance of a retirement account at the end of the prior year is relatively straightforward – simply pull out the year-end statement and see the value. Even if retirement accounts are being transferred from one plan administrator or IRA custodian to another, by the end of the year, the money will be in one account or another, with the "old" account reduced by the value of the transfer out, and the "new" account increased by the amount that transferred in.

However, in some scenarios, the transfer may actually be in "mid-course" at the moment the year ends, especially in situations where funds weren't (or couldn't be) transferred as a trustee-to-trustee transfer, and instead were conducted as an actual "rollover" – where the account balance is distributed to the account owner, who individually takes possession of the money, deposits it into a checking or brokerage account, and then "rolls over" the funds within 60 days (after the start of the new year).

Treasury Regulation 1.401(a)(9)-7 for employer retirement plans, and the associated Treasury Regulation 1.408-8, Q&A-7 for IRAs, provides guidance on how to handle such situations. Where transfers are still underway at year end, the "distributing plan/account" – the source that the transfer was taken *from* – simply uses its year-end account balance, reduced as applicable by the amount that was already distributed/transferred by year end. However, the *receiving* account, where the funds are rolled in, must have its year-end account balance retroactively adjusted

and increased by the value of the assets rolled in. Thus, even if the roll-in finishes in the *following* calendar year, it is still treated as being associated with the new account as part of its prior-year account balance associated with the year the money was originally distributed (to ensure that retirees don't "vanish" portions of their retirement accounts with year-end rollovers just to avoid or minimize RMDs!).

Example 4. Jeremy is 72 and has a \$300,000 401(k), and decides to transfer \$100,000 of the account to an existing IRA worth \$500,000, that has more appealing investment opportunities. The 401(k) plan administrator cannot facilitate a trustee-to-trustee transfer, and as a result distributes a \$100,000 check to Jeremy on December 22nd of 2016. Jeremy deposits the \$100,000 check into his checking account, and completes the rollover by depositing the funds into the existing IRA on January 7th of 2017.

As a result of this rollover, Jeremy's 401(k) account finishes with a \$200,000 account balance (the original \$300,000 balance, less the \$100,000 distribution) at the end of 2016, and Jeremy will be obligated to take an RMD from the 401(k) plan in 2017 based on the \$200,000 balance. However, Jeremy's 2017 RMD for his IRA will be calculated based on a \$600,000 account balance, including the \$500,000 year-end balance at the end of 2016, *plus* the \$100,000 that was contributed in 2017 but came out during the 2016 tax year (and this is still attributable to the account in 2016 for RMD purposes).

Notably, in the event of a Roth conversion with a subsequent recharacterization, Treasury Regulation 1.408-8, Q&A-8(b) also requires that the recharacterization amount be added back to the end-of-prior-year account balance to determine the appropriate RMD. The end result is akin to the scenario where an IRA rollover completes after the end of the year; the amount that was recharacterized must still be considered for RMD purposes, and holding an amount in Roth-conversion-and-recharacterization-limbo does not allow RMDs to be avoided. Including any subsequent growth that might have happened during the transition period.

Example 5. Charlie is 73 years old, and did a partial Roth conversion of \$125,000 of his \$400,000 IRA to a Roth at the end of last year. Immediately after the conversion, his IRA was worth only \$275,000. However, Charlie discovers as he prepares his tax return, that he converted so

much that he drove his tax bracket up to the 28% rate, and had only wanted to fill the 25% tax bracket. As a result, he recharacterizes \$28,000 of his conversion, which, due to interim growth, requires actually recharacterizing \$29,000 of assets back to his IRA.

The end result is that Charlie must still report \$97,000 of his Roth conversion as income (the \$125,000 original conversion, reduced by the \$28,000 recharacterization), but for RMD purposes, his prior-year-end balance is \$275,000 + \$29,000 (the actual amount recharacterized, including growth) = \$304,000. Notably, this actually puts Charlie in a slightly worse position than he would have been in by just not converting that \$28,000 in the first place – as the growth *after* the end of the year must be added back to his RMD calculation from the *prior* year-end. However, the difference is fairly minimal in impact, as Charlie's RMD at age 73 is only 4.05% of his account balance, resulting in an extra \$40.50 of RMDs, and \$10.13 of additional taxes (at a 25% tax rate).

It's important to bear in mind that because a Roth recharacterization can occur as late as October 15th of the year *after* the Roth conversion, it could be well into the current year before a late-year recharacterization retroactively impacts the prior-year-end account balance for calculating the current year's RMD. A Roth recharacterization that occurs in October means the account owner only has 3 more months in the current year to (re-)calculate and then take any remaining RMDs that might now be due given the retroactive adjustment to the RMD calculation.



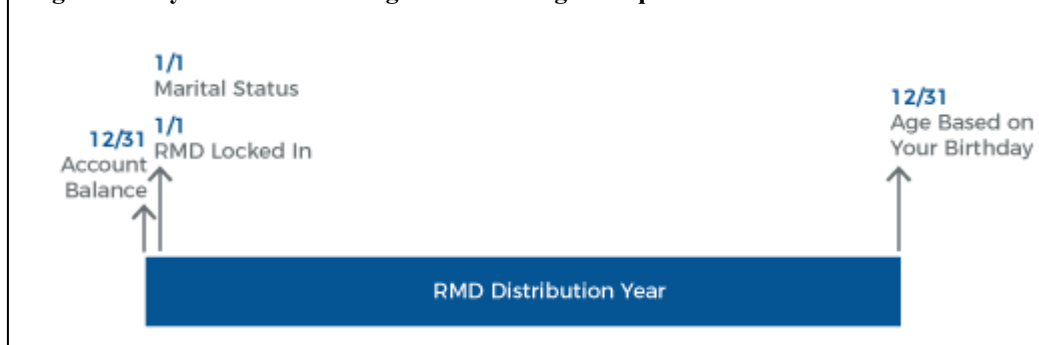
Planning Tip: While it's prudent to calculate RMDs at the beginning of the year, to ensure that all affected retirement account owners know the amount that needs to be taken, it's important to revisit RMDs for all clients towards the end of the year – after all prior-year rollovers and any Roth recharacterizations have been completed – to ensure that the amount of the RMD didn't change after the fact!

Executing The Required Minimum Distribution

As noted earlier, the RMD is calculated as a fraction, where the numerator is the account value at the end of the prior year, and the denominator is the "applicable distribution period", based on the joint life expectancy of the individual and a beneficiary (either a hypothetical

beneficiary who is 10 years younger, or the actual life expectancy of a spouse who is the sole beneficiary and is more than 10 years younger). And the life expectancy factor is in turn determined using the appropriate

Figure 4. Key Dates And Timing For Executing A Required Minimum Distribution



life expectancy tables, based on the age that the individual (and where applicable, his/her spouse) will be at the end of the *current* year (i.e., the age he/she will attain *on* his/her birthday in the current year).

As long as an individual is alive at the beginning of the year – i.e., he/she alive at 12:01AM on January 1st – an RMD *will* be due for that year, and must be taken (either as cash, or an in-kind distribution of securities). The deadline for taking the RMD for the current year is the end of the year (i.e., December 31st), as shown in Figure 4. There is a special extension for the very first RMD (as discussed in the next section). If an individual passes away before taking his/her RMD for the current year, it must still be taken by his/her beneficiary by the end of the current distribution year.

When there are multiple retirement accounts, each account will have its own RMD calculation, and the RMD must be taken from that account to satisfy the RMD obligation for that account. However, in the case of IRAs, special rules apply to determine which account(s) can be withdrawn from to satisfy the RMD obligation, under the so-called RMD aggregation rule for IRAs, as discussed below.

The RMD Aggregation Rule For IRAs

Each and every pre-tax retirement account must be evaluated to determine whether the required beginning date has been reached for that account, and if so, the amount of the RMD obligation for that account.

In the case of employer retirement plans, including 401(k) and 403(b) plans, profit-sharing plans, etc., the RMD for that account must then be taken from that particular account.

However, a simpler RMD aggregation process applies to IRAs. Under Treasury Regulation 1.408-8, Q&A-9, any distribution from *any* IRA can be used to satisfy the RMD obligation for *all* of that individual's IRAs.

In other words, once the RMD amount is calculated for each IRA separately, the amounts are then totaled up, and the only requirement is that the total amount must cumulatively be withdrawn from *any* IRAs to satisfy the RMD obligation for *all* IRAs.

Example 6. Christopher is turning 73 years old this year, and has two IRAs. The first, worth \$500,000, has his 61-year-old wife named as the sole beneficiary. The second, worth \$100,000, has named his 37-year-old son as the beneficiary.

For the first account, where the sole beneficiary is a more-than-10-years-younger spouse, the joint life expectancy factor is 26.1, resulting in an RMD of $\$500,000 / 26.1 = \$19,157.09$. The second account, however, will use the Uniform Life Table, and a life expectancy factor of 24.7, resulting in an RMD of \$4,048.58.

As a result, Christopher's total RMD obligations for the year are $\$19,157.09 + \$4,048.58 = \$23,205.67$. And ultimately, Christopher can take that \$23,205.67 from *any* of his IRAs to satisfy his RMD, regardless of which account the calculation was originally associated with.

Notably, the RMD aggregation process applies *only* to IRAs (including SEP and SIMPLE IRAs, but not any other employer retirement plans like 401(k)s, 403(b)s, or profit-sharing plans). In addition, it applies only to *that individual's* own IRAs (thus, for instance, the RMDs of a husband and wife are not aggregated, and each must take their respective RMDs from their own respective IRAs). Furthermore, the RMDs from any inherited IRAs are not aggregated with the RMDs from his/her own IRAs, nor are inherited IRAs aggregated with each other (although all inherited IRAs for a single beneficiary *and from a single decedent* may be aggregated for calculated that inherited RMD). And since Roth IRAs have no lifetime RMD obligations at all, Roth accounts (and distributions from Roth

accounts) are not aggregated with nor used towards satisfying the RMDs for non-Roth traditional retirement accounts.



Planning Tip: The RMD aggregation rule provides substantial flexibility regarding which IRA account(s) will be used to fund the RMD obligation for all accounts. In some cases, retirees may prefer to satisfy the RMD obligation using IRAs holding more liquid assets, to avoid the need to sell less liquid assets. In other cases, the RMD aggregation rule may be used to fund RMDs from lower-growth IRAs (e.g., an IRA holding bonds, or a CD) while maintaining higher-growth IRAs. Though notably, an RMD *can* be satisfied by making an in-kind distribution of an asset, so it's *not necessary* to actually liquidate an asset and transfer cash out of the IRA in order to fulfill the RMD obligation.

Order Of Distributions & Coordinating RMDs And Rollovers

The RMD portion of a retirement account is not eligible for rollover, under IRC Section 408(d)(3)(E); as a result, if a retirement account is being rolled over, the RMD should be taken *before* the rollover or as a part of the rollover distribution (with only the remainder actually being rolled back into a subsequent retirement account). The fact that an RMD cannot be rolled over also means an RMD cannot be applied towards a Roth conversion.



Planning Tip: To ensure compliance with the RMD rules when rollovers and/or Roth conversions are occurring, it's a best practice to take the RMD first (i.e., early in the year), to ensure that any such rollovers or Roth conversions do not accidentally include the ineligible RMD portion of the account.

In addition, an RMD, once taken, is irrevocably distributed as well, again because the RMD amount is not eligible for rollover. And by default, any distribution from a retirement account that is subject to RMDs is *presumed* to be made first to satisfy the RMD, under Treasury Regulations 1.402(c)-2, Q&A-7, and 1.408-8, Q&A-4. Only after all RMDs for the current year have been taken, is any subsequent distribution treated as a normal non-RMD distribution.

Example 7. Charles is 72 years old, and has a required minimum distribution of \$5,000 in the current year. Charles has been systematically

withdrawing \$1,000/month from his retirement account to sustain his retirement lifestyle.

As a result, the first five distributions from January to May will automatically be deemed the distributions to satisfy his RMD that year, as every distribution from a retirement is presumed to be satisfying the RMD for the current year if the RMD hasn't already been taken. Once \$5,000 of cumulative distributions have actually occurred – enough to satisfy Charles' RMDs – any subsequent distributions will be treated as “normal” distributions (and thus would be eligible for rollover as well).

To the extent that a distribution is partially non-taxable (i.e., as a return of previous non-deductible/after-tax contributions to the retirement account), the full amount of the distribution (both taxable and non-taxable portions) still count towards satisfying the RMD, under Treasury Regulation 1.401(a)(9)-5, Q&A-9.

The Onset Of RMDs And The Required Beginning Date

As noted earlier, the standard rule is that each year's required minimum distribution must be taken by December 31st of that year. However, a special rule applies to the *first* RMD – i.e., the RMD for the year in which the individual turns age 70 ½ – that allows a 3-month grace period, until April 1st, to complete that first RMD. This date – April 1st of the year after turning age 70 ½ – is known as the “Required Beginning Date”. (In the case of a still-working employee who is not a more-than-5% owner, the Required Beginning Date is April 1st of the year after retiring, for that employee's retirement plan accounts under that particular business.)

Notably, any distribution that occurs in the year the individual turns age 70 ½ will still count towards satisfying the RMD for that year, and individuals can fully satisfy their first RMD in that year without waiting past the end of the year. However, to the extent the first RMD is *not* taken by the end of the year, it can be (and must be) taken by April 1st of the following year.

To help make IRA owners in particular aware of the onset of their RMD obligations, since 2003, the custodians of IRA accounts have been required to report to account owners (and the IRS) that there is an RMD for the current year, and what the RMD amount would be (at least based on the Uniform Life table), as discussed in the sidebar (next page).

Timing Of The First (And Second) Required Minimum Distributions

Even with the deadline for the first RMD delayed until the first three months of the following year, it's important to recognize that the *second* RMD, for the second distribution year, will *also* have to be taken in that second year, as shown in Figure 5 (next page).

As a result, delaying the first RMD will result in a "doubling up" of RMDs in the second year, which can cause adverse tax consequences to the extent that the cumulative total of both RMDs drives the individual into a higher tax bracket.

In the event that an individual is eligible for the still-working exception to RMDs as a not-more-than-5% owner, the first RMD distribution year is the year he/she retires, which means the Required Beginning Date for that plan/account will be April 1st of the year after retirement. As noted earlier, though, any *other* retirement accounts will still have a Required Beginning Date of April 1st of the year after turning age 70 ½.



Planning Tip: A still-working employee could potentially roll other retirement accounts *into* the existing employer retirement plan, and then delay RMDs on all retirement accounts that are now part of the employer's retirement plan. Of course, this assumes the employer retirement plan allows

RMD Reporting Rules For IRA Custodians

Beginning in 2003, under Treasury Regulation 1.408-8, Q&A-10, the custodian or trustee of an IRA is required to report to the account owner that an RMD is due for the current year (and provide an offer to calculate the RMD amount), or alternatively can just outright provide the account owner a calculation of the amount of the annual RMD obligation from that IRA. In either case, the RMD notification must also show the due date for that RMD (which will generally be December 31st of the current year, except in the case of the first RMD that is due by April 1st of the following year). The notification of this RMD due date and calculation itself must be provided by January 31st of that year, for the RMD that will be due that year.

Thus, as long as the IRA owner is alive at the beginning of 2018, the IRA custodian will be required to provide a calculation of the RMD to that IRA owner by January 31st of 2018, based on the account balance on December 31st of 2017, and how old the IRA owner will be on December 31st of 2018.

Notably, when reporting the calculated amount for an RMD, the IRA custodian is permitted to assume that the beneficiary is *not* a more-than-10-years-younger spouse, and rely solely on the Uniform Life Table. As a result, if the (sole) beneficiary of the IRA actually *is* a more-than-10-years-younger spouse, the RMD calculation will overstate the actual RMD obligation. However, since the RMD notification is purely for informational purposes, the IRA owner *is* permitted to take the smaller and more favorable required minimum distribution amount based on the joint life expectancy table (where permitted), notwithstanding that the IRA custodian's reported amount was higher (based on the Uniform Life table).

Beginning in 2004, IRS Notice 2002-27 also requires that the IRS custodian report directly to the IRS on Form 5498 whether there is an RMD obligation for the account, by checking Box 11 of that form (if an RMD is due for that tax year). Reporting the actual amount of the RMD obligation on Form 5498 is optional. However, since 2009, IRA custodians have had the choice to report the RMD due date and amounts in boxes 12a and 12b of Form 5498, and if the Form 5498 is sent with those boxes completed by the January 31st deadline, the Form 5498 itself can satisfy the IRA custodian's reporting requirements to the IRA owner as well.

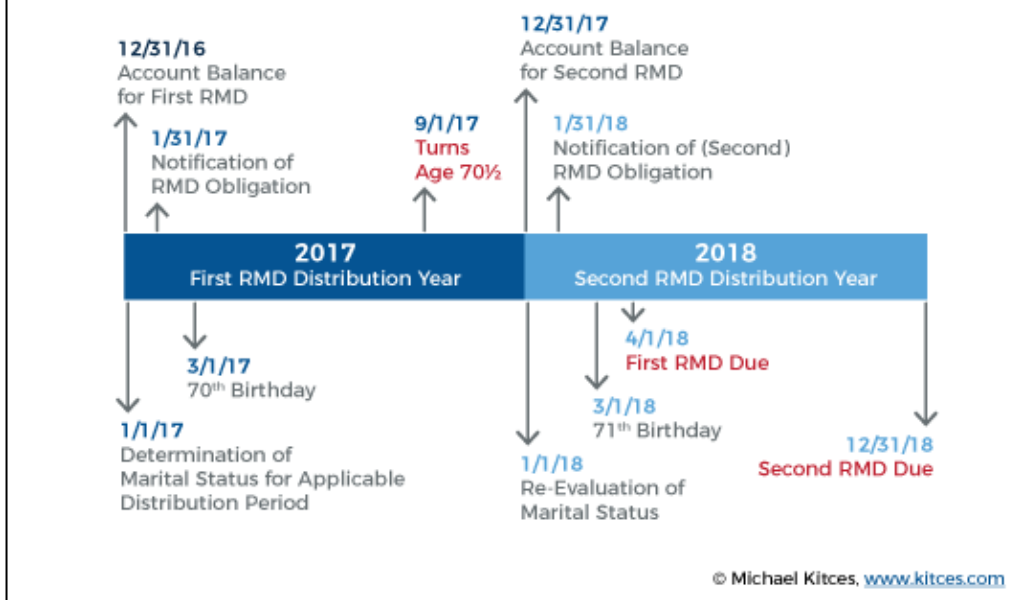
In practice, the actual process of notification varies; some IRA custodians provide the calculation alongside the end-of-year IRA statement, while others provide a separate RMD notification, and others simply furnish a Form 5498 (which must be prepared for the IRS anyway) to satisfy the custodian's notification requirement.

In any event, though, no reporting of the RMD obligation (on Form 5498 or to the IRA owner directly) is required for inherited IRAs; only for lifetime RMD obligations for the original (still-alive) IRA account owner. In addition, there are no reporting requirements for RMD obligations from defined contribution employer retirement plans (e.g., 401(k) or 403(b) plans, profit-sharing plans, etc.).

Thus, even if retirees already received an automatic calculation of their RMDs, it's still important to verify whether the (sole) beneficiary is a surviving spouse, as if that spouse is *also* more-than-10-years-younger, recalculating the RMD using the joint life expectancy table will produce a more favorable (i.e., smaller) RMD.

outside dollars to be rolled into the plan in the first place. And that the employee is *not* a more-than-5% owner. Which also means the strategy doesn't work in the employee's *own* business, nor can it be done via an individual 401(k) plan (since that would only be available for a self-employed individual, who by definition is the 100% "owner" of the self-employed business).

Figure 5. Distribution Timeline For The First (Two) RMD Obligation(s)



Consequences Of Missing A Required Minimum Distribution

Under IRC Section 4974, the failure to take the full amount of a required minimum distribution results in an excise penalty tax equal to 50% of the RMD shortfall amount.

Example 8. Henry had a total RMD obligation this year of \$8,000, but he only took \$3,000 of distributions this year. As a result, Henry will face the penalty tax for failing to take his full RMD, and the penalty would be equal to \$5,000 (shortfall) x 50% = \$2,500. If Henry had missed his entire RMD, the penalty would be \$8,000 x 50% = \$4,000.

In addition to owning the 50% penalty tax for failing to take an RMD, the IRA owner must still actually *take* the RMD amount as well – once the error is discovered – and incur any income taxes that are due when the proper distribution actually occurs.

A failure to take an RMD, and the associated penalty, is reported on IRS Form 5329 – which can also be used to request a waiver of the RMD penalty, as discussed in the sidebar (next page).

Special Circumstance Rules For Required Minimum Distributions

Beyond the “standard” rules for required minimum distributions, a number of “special circumstances” rules and regulations have emerged over the years as well.

In some cases – such as the rules for making Qualified Charitable Distributions from IRAs – there is a valuable planning opportunity to improve the outcome of the RMD. In other cases – such as with the valuation of IRA annuities for RMD purposes – the intent of the rule is to crack down on perceived abuses. And for some situations – such as the use of immediate annuities, including longevity annuities, inside of retirement accounts – the special rules are necessary simply to handle a genuinely “unusual” situation that doesn’t fit the normal scope of the RMD rules.

These special circumstances are discussed in further detail in the following sections.

Satisfying An RMD With A Qualified Charitable Distribution

A “Qualified Charitable Distribution” (QCD) under IRC Section 408(d)(3) is a distribution made *directly* from an IRA to a (public) charity.

In order to make a QCD, the IRA owner *must* be at least age 70 ½ (and notably, the IRA owner must actually *be* age 70 ½ or older on the date of distribution itself, not merely turning 70 ½ sometime that year). The maximum dollar amount of a QCD for any individual from his/her IRAs is limited to \$100,000/year, though the limitation is on a per-taxpayer basis, which means a married couple can *each* do up to \$100,000/year, for a total of \$200,000 in QCDs (as long as each spouse’s \$100,000 QCD share comes directly from that spouse’s own individual IRAs).

Notably, only an IRA can fund a QCD, and not any type of employer retirement plan (nor a SEP or

SIMPLE IRA, if they are still “active” plans and receiving ongoing contributions). And the charitable distribution itself must actually go to a bona fide public charity (i.e., as described under IRC Section 170(b)(1), which generally includes educational, charitable, religious, and other 501(c)(3) charitable entities), but not to a private foundation or a charitable supporting organization, nor to a donor-advised fund.

In addition, for a QCD to qualify as a charitable distribution, it must be a donation that *otherwise* would have been fully deductible, for which the IRA donor receives no kickbacks or other “quid pro quo” benefits (as receiving something in return would limit the donor’s deduction to only the *net* amount contributed,

Requesting A Waiver Of The 50% Penalty Tax For Failing To Take An RMD

In a world where making an excess contribution to an IRA is a ‘mere’ 6% penalty, making an underpayment of estimated taxes accrues an interest penalty of just 4%/year, and failing to pay your tax bill on time is a 0.5%/month penalty, the whopping 50% penalty tax for failing to take an RMD is arguably one of the harshest under the tax code.

Fortunately, though, it’s also one of the most straightforward to request (and receive) a waiver. IRC Section 4974(d) explicitly grants the IRS and Treasury the ability to waive the penalty if the RMD shortfall was due to “reasonable error”, and that “reasonable steps” are taken to remedy the shortfall (once discovered).

In practice, this means that if/when a shortfall is discovered – where the full RMD wasn’t taken – the first step should always be to take the appropriate amount, and remedy the shortfall, as quickly as possible. Waiting to correct a belated RMD, once the mistake is known, only increases the risk that the IRS will assess the penalty and refuse to waive it (for failing the “reasonable steps taken to remedy the shortfall” requirement).

Then, at the end of the *current* tax year when the corrective RMD occurred (and after taking the *current* year’s RMD in full as well!), file Form 5329 to report the failure to take an RMD in Section IX (“Additional Tax on Excess Accumulation in Qualified Retirement Plans”). The amount that the RMD *should* have been is reported on line 52, and the actual distributions taken are reported on line 53, but instead of reporting the shortfall on line 54, report the amount you want waived (and the letters “RC” for reasonable cause) next to line 54, enter \$0 on Line 54 itself, and attach a Letter of Explanation regarding why the RMD was missed and the steps taken to remedy it.

Fortunately, RMD mistakes are common enough that the IRS allows taxpayers to submit a request for waiving the failed-RMD penalty *without actually paying the penalty up front*; in other words, simply report that a mistake occurred on Form 5329, request a waiver with an attached Letter of Explanation, and if the IRS is *not* willing to grant the waiver, the Service will reply with a notification of the penalty payment amount that is now due.

On the plus side, “missed RMDs” are far less frequent today than they once were, thanks to the requirement that IRA custodians notify account owners of their RMD obligations and assist in calculating the amount. On the other hand, even if the IRA custodian fails to properly notify the IRA owner for some reason, the RMD obligation still rests on the IRA owner themselves (which means “failure to receive notification” doesn’t automatically avert the penalty). And the fact that IRA custodians are notifying both the IRA owner, *and the IRS via Form 5498*, means a missed RMD is more likely than ever to be caught, even if not voluntarily reported. However, failing to receive a reminder notification from the IRA custodian might at least be reasonable grounds for *requesting* a waiver of the penalty.

Ultimately, this means that if a botched RMD is discovered, don’t ignore it or try to cover it up. The best odds of a favorable resolution are to promptly fix the distribution, and *proactively* report the missed RMD, in order to make the penalty waiver request via Form 5329. As the odds of a waiver are far less likely if the RMD wasn’t promptly fixed and the IRS catches it later (which they probably will, thanks to the Form 5498 reporting!).

and thus fail the “fully deductible” QCD requirement). In practice, this limitation also prevents any type of split-interest charitable trust (e.g., a charitable remainder trust or charitable lead trust) from being an eligible QCD beneficiary.

The rules permitting a “Qualified Charitable Distribution” (QCD) from an IRA were first created under Section 1201 of the Pension Protection Act of 2006. Unfortunately, though, the original rules were effective for only two years, beyond which the favorable treatment for QCDs would lapse. And for more than a decade, the rules went through a series of lapses and reinstatements, and more lapses and more reinstatements, until finally becoming permanent under the Protection Americans from Tax Hikes (PATH) Act of 2015 (as shown in Figure 6, below).

The benefit of doing a QCD is that the IRA distribution itself will not be treated as a taxable event. The donation will not be eligible for a charitable deduction either, but only because by definition the distribution directly from a (pre-tax) IRA to a charity is *already* a fully pre-tax contribution. In fact, IRC Section 408(d)(8)(D) explicitly requires that any qualified charitable distribution from an IRA is deemed to come from the taxable portion of the account first (as opposed to the typical pro-rata rule). Yet because the distribution itself is paid out from the IRA, it will still satisfy any required minimum distribution obligations for the year. (And there *should* be an RMD obligation for the current year, since by definition the QCD rules only apply for those who have reached age 70 ½!)



Planning Tip: For those who are over age 70 ½, and already plan to donate to a charity in the current year anyway, doing a QCD directly from the IRA to the charity can effectively “kill two birds with one stone”, fulfilling a fully-pre-tax charitable contribution, *and* satisfying the RMD obligation for the year. Which is more effective than simply taking the RMD (and reporting it in income), and making a separate charitable donation (and obtaining the charitable deduction), as in practice the (itemized) deduction rarely perfectly offsets the (above-the-line) income. Though notably, a QCD in many circumstances will still be less effective than just taking the RMD, and separately donating *appreciated investments* to (mostly) offset the income from the RMD (and permanently avoid the long-term capital gain on the investment in the process!).

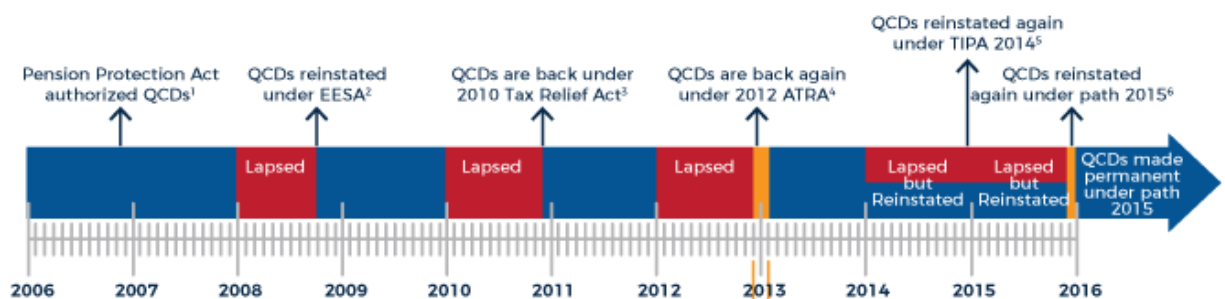
Timing Issues When Completing A QCD (To Fulfill RMD Obligations)

It’s important to coordinate the timing of a QCD if intended to satisfy an RMD obligation.

Because distributions from a retirement account are always deemed to be applied towards the RMD first, *the QCD must be the first IRA distribution of the year in order to be used towards the RMD for the year.* If other IRA distributions occur first, and a QCD occurs later, the earlier IRA distributions will count towards the RMD, and not the QCD.

In addition, because RMDs cannot be rolled over, there is no way to “undo” an earlier RMD to have the QCD

Figure 6. The Path To Permanence For Qualified Charitable Distributions



- 1 Pension Protection Act of 2006
- 2 Emergency Economic Stabilization Act of 2008
- 3 Tax Relief, Unemployment Insurance Reauthorization & Job Creation Act of 2010
- 4 American Taxpayer Relief Act of 2012
- 5 Tax Increase Prevention Act of 2014 (Tax Extenders)
- 6 Protecting Americans From Tax Hikes Act of 2015

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count towards the RMD later instead. Of course, it's still permissible to *do* a QCD, even if the annual RMD obligation has been met – as long as the QCD is otherwise eligible – but it can't count towards (or undo) the tax consequences of the RMD that was already completed.

Example 9. Henry had a \$9,300 RMD obligation for the current 2017 tax year. In February, he took a \$9,300 distribution to satisfy his entire RMD. In March, Henry realizes that it may have been better for him to do a QCD instead, as he was planning to contribute to charity later in the year anyway. However, even if Henry now does a QCD, it cannot be applied towards his RMD (which was already satisfied), nor can he undo his prior RMD (which is irrevocable once distributed). At best, Henry can simply take the \$9,300 distribution he already took from his IRA, donate it to a charity, and claim a \$9,300 charitable deduction as an itemized deduction on Schedule A, and hope that it at least mostly offsets his prior taxable distribution. Or he can still donate from his IRA to the charity as a QCD, *on top* of the \$9,300 he already took out, if he wishes to use more of his IRA to fulfill his charitable goals (which at least reduces the RMD and future tax exposure of the IRA).

It's also important to recognize that a QCD for an IRA *must* be done in the actual tax (calendar) year towards which it's being applied. Which means for someone who is just turning age 70 ½, and has his/her first RMD obligation, the RMD can be delayed as late as April 1st of the following year, but the QCD only counts in the year in which it occurred.

Example 10. Janet will be turning 70 ½ on September 12th of 2017, which makes 2017 her first required minimum distribution year. Her first RMD, based on her December 31st account balance from 2016, and the age 70 life expectancy factor, will be \$6,500. Janet has as late as April 1st of 2018 to complete her first RMD. However, if she wants/plans to give to charity in 2017 and wants to use her charitable donation to satisfy her RMD, she needs to do the QCD by December 31st of 2017. If she does so, the QCD will count towards her 2017 RMD (assuming she hasn't already done any other IRA distributions in 2017).

Of course, if Janet waits until early 2018 to complete her RMD, she could still do a QCD in 2018 to satisfy the RMD. However, if Janet's IRA was much larger, and her RMD was not \$6,500 but \$65,000, she would not be able to

fully qualify her RMDs as QCDs in 2018, as her 2017 RMD (taken in early 2018), plus her even-larger 2018 RMD (as she'll be one year older), would cumulatively add up to more than the \$100,000/year limit on QCDs.

As this example highlights, those with large IRAs and sizable RMDs need to be cautious with the timing of their first RMD to ensure that the first two RMDs don't double up in a single year, not only because it can drive up the tax bracket, but also because it can drive the individual over the annual QCD contribution limit.

Execution And Tax Reporting Of A Qualified Charitable Distribution

The actual execution of a QCD itself is relatively straightforward. As long as the IRA owner is already at least age 70 ½ on the date of distribution, simply submit a distribution request form to the IRA custodian, requesting a distribution for the appropriate dollar amount, and that the check be made payable *directly* to the charity. Ensure that no tax withholding is being done as a part of the distribution, as it shouldn't be necessary (given that a QCD is not a taxable event), and because the money *must* actually go *to* the charity to qualify (and being sent to the IRS as tax withholding wouldn't count).

The key administrative requirement to completing a QCD successfully is that the distribution check must be made payable *directly* to the charity. If the funds are paid out to the IRA owner, and are then "passed along" to the charity (e.g., by writing a new contribution check, or endorsing the distribution check to the charity), it is a taxable distribution to the IRA owner (and a subsequent charitable contribution), not a direct QCD. Though notably, under IRS Notice 2007-7, Q&A-41, it is permissible for the check to be *sent* to the IRA owner, as long as the check is *payable* to the charity and the IRA owner is merely passing along the physical check.

One common point of confusion, though, is the tax reporting *of* a qualified charitable distribution. Because unfortunately, there's no box to "check" for the IRA custodian on Form 1099-R to report that a QCD was paid directly to a charity and non-taxable.

Instead, Form 1099-R will simply report the full amount of the distribution in Box 1, and a Distribution Code of "7" in Box 7, signifying a "normal" taxable distribution. It's then up to the taxpayer on Line 15 of Form 1040 to enter the full amount of the gross distribution in box 15a (for IRA distributions), reduce the gross distribution by

the amount of the QCD when reporting the taxable amount at line 15b, and write next to line 15 “QCD” to explain why not all of the gross distribution was taxable.

Example 11. Betsy took a total of \$15,000 of IRA distributions, of which \$8,000 was a QCD. Betsy’s Form 1099-R will report \$15,000 of gross distributions, and Betsy should show the full \$15,000 on line 15a of the tax return. However, on line 15b, Betsy would report \$15,000 - \$8,000 = \$7,000 as the taxable amount, and the note “QCD” in the margin next to line 15 to explain the difference between the two.

The Intersection Of (Qualified) Annuities And RMDs

The tax treatment of annuity contracts varies depending on whether they are “qualified” or “non-qualified” annuities. A qualified annuity is one that is purchased inside of a tax-qualified (i.e., tax-preferenced) retirement account, such as an IRA or a 401(k). By contrast, a non-qualified annuity is purchased with outside after-tax dollars from taxable accounts.

From a tax perspective, the distinction is important, as non-qualified annuities are eligible for their own specialized tax treatment under IRC Section 72, including that contributions are after-tax (thus why they are non-qualified), growth being tax-deferred, and gains being fully taxable as ordinary income at the time of distribution. Deferred non-qualified annuities have those gains taxed on a gains-first distribution rule, while annuitized contracts are eligible for the so-called “exclusion ratio” treatment (where a portion of each regular payment is principal and the remainder is taxable as gain).

In the case of qualified annuities, the tax rules of the retirement account wrapper itself are controlling. Thus, an IRA annuity is simply an IRA that happens to own an annuity; its tax rules are just the same as any other IRA, including the taxation of distributions, and the obligation to take required minimum distributions upon reaching age 70 ½.

However, there are three special situations that can apply where annuities are held within a tax-qualified retirement account: the valuation of RMDs in a deferred annuity, the application of RMDs when a retirement account is annuitized, and the coordination

of RMDs when the IRA is annuitized as a longevity annuity (also known as a deferred income annuity) where payments aren’t scheduled to begin until after age 70 ½.

RMD Valuations For Deferred Annuities With Guaranteed Benefit Riders

While the general rule for calculating an RMD for a retirement account is that it’s based on the “account balance” from December 31st of the prior year, special rules apply when determining the value of a deferred annuity held inside of a retirement account.

The reason is that in today’s world of deferred annuities with potentially significant death benefit or living benefit riders, “just” looking at the account balance alone may substantially underestimate the true value of the contract, to the point of distorting tax outcomes.

For instance, if an annuity contract has a current cash value of \$100,000, and a death benefit rider that is locked in at \$300,000, is it really fair to say the value of the contract is “just” \$100,000 for RMD purposes, when it may someday soon pay out another \$200,000 in extra death benefits? Or in the extreme, where some annuity contracts allow withdrawals to reduce guarantees on a dollar-for-dollar basis, what if the owner of the aforementioned annuity withdrew \$99,000, leaving a contract behind with a \$1,000 cash value, and a \$201,000 death benefit? Is it really appropriate to view the contract as being worth “just” \$1,000, especially if the annuity owner is very old, such that the \$1,000 will likely turn into that \$201,000 death benefit sooner rather than later?

To close the potential loophole, in 2005 the Treasury issued Regulation 1.401(a)(9)-6, Q&A-12, which stipulated that in the case of a deferred annuity inside of an IRA, the determination of the RMD must be based on the “entire interest” under the annuity contract, which includes both the account balance, and the “actuarial present value” of additional benefits and guarantees. Thus, for instance, if an annuity had a \$100,000 cash value but a \$300,000 death benefit, the value of the annuity would be \$100,000 of cash *plus* the actuarial value of the extra \$200,000 death benefit based on the annuity owner’s age (in essence, \$100,000 *plus* the cost of \$200,000 term insurance for that year for someone of comparable age).

To at least partially simplify the process, though, the Treasury Regulations do state that the calculation of the

actuarial present value of additional benefits can be done using “reasonable” actuarial assumptions, but *without* regard to the individual’s health; thus, there’s no requirement to *individually* underwrite the economic value of any benefit guarantees (based on that person’s specific health circumstances), but simply to evaluate the likely prospective value based on the individual’s age, and the cash value and level of death benefit (or living benefit) guarantees.

In addition, the Regulations state that the actuarial present value of additional benefits can still be ignored if either:

- a) The additional benefits add no more than 20% to the value of the contract, where any future withdrawals reduce benefits on a pro-rata basis and the death benefit guarantee is only a return-of-principal guarantee; or
- b) The *only* additional benefit is a return-of-principal death benefit guarantee (in which case the actuarial present value can be ignored, regardless of how much additional value it provides)

Notably, these exceptions still mean that any “old” annuity contracts that provide living benefit riders that allow for dollar-for-dollar withdrawals, or any annuity contracts that have “enhanced” death benefit guarantees (beyond just a return of principal guarantee), are not eligible for the exceptions and *must* include the actuarial present value of the additional benefits. In addition, even living benefit riders that allow for pro-rata distributions must still be considered in the valuation for RMD purposes if their value is “substantial” (and would increase the RMD valuation by more than 20% of the total account value).

In extreme cases, it’s important to note that the RMD obligation could conceivably even exceed the *entire* cash value of the annuity, in scenarios where the contract is almost depleted, but the remaining guarantees are substantial – for instance, in a situation where ongoing withdrawals have reduced the annuity contract’s cash value down to \$1,000, but there is still a large death benefit or living benefit rider remaining that’s worth far more. Fortunately, in situations where the contract is depleting but a living benefit rider remains, there is often an option in the contract to effectively “annuitize” into guaranteed lifetime income, which relies on different RMD rules for annuitization (as discussed below). In addition, because RMDs for an IRA can be satisfied from *any*

IRA under the RMD aggregation rule, it may be feasible to simply draw the required amount (after considering the actuarial present value of additional benefits) from another retirement account. Nonetheless, in the case of a contract that just has a large death benefit guarantee, where distributions are ongoing or at least planned, it is important to plan in advance for a potential draw-down. Though fortunately, because the value of term insurance is only a small percentage of the death benefit, and the RMD obligation is only a percentage of *that*, the risk is unlikely.

In practice, though, the biggest complication in determining RMDs for qualified annuities with substantial additional benefits is simply determining the appropriate “actuarial present value” of the additional benefits in the first place. In most cases, annuity companies will provide a reasonable estimate, but some do not, and others do not provide very “sophisticated” or accurate valuations.

For instance, one annuity company simply reports that the value of an annuity with a \$100,000 cash value and a \$300,000 death benefit as \$300,000, and suggests that if the annuity owner wants to substantiate a lower valuation (which is likely, given that the actuarial cost of \$200,000 of life insurance is not \$200,000!), he/she can obtain their own valuation (at their own cost). This is permissible, inasmuch as a “conservatively” high valuation will produce a larger-than-necessary RMD, and more than ensures that the minimum amount *is* taken... though it may result in a far larger withdrawal than was otherwise truly necessary.

On the other hand, if the retiree is already substantially withdrawing on the qualified annuity for his/her own retirement income needs, more-than-enough in distributions may already be occurring anyway. In other words, the retiree may already be fulfilling his/her RMD obligations simply with the ongoing retirement income spending withdrawals that are occurring anyway, especially in the case of living benefit riders *designed* to provide ongoing retirement distributions.

Nonetheless, qualified annuity owners should be cognizant both of the importance of including the actuarial present value of additional benefits, and that the “valuation” provided by the annuity company may, in some situations, be worth a second look and even a second-opinion valuation. (Retirees and their advisors can seek out third-party actuaries for a third-party valuation if necessary, where the prospective size of the RMD and the tax consequences are large enough to merit paying for an independent valuation.)

Satisfying RMD Obligations When Annuitization Occurs

The early days of employer retirement plans in the aftermath of World War II were built around pensions, which would pay a lifetime income to the retiree upon reaching retirement. As a result, there were no “required minimum distribution” obligations; instead, there were simply requirements to ensure that the lifetime pension annuity payment was reasonable (i.e., payments for life, that were either level or only adjusting for inflation, and not just constructed with back-loaded payouts that would amount to inappropriate tax deferral). It was only later, when defined contribution plans were introduced, where there was an *account balance* that could be retained for the long run and *not automatically pensionized at retirement*, that it became necessary to establish required minimum distribution rules at all.

As a result of these two historical channels – rules for “reasonable pension annuity payments” from defined benefit plans, and “required minimum distribution” obligations from defined contribution plans – today’s Treasury Regulations still include two separate sets of rules to handle each situation. The typical RMD obligation from a defined contribution plan (including an IRA) is covered under Treasury Regulation 1.401(a)(9)-5 (and for IRAs, Treasury Regulation 1.408-8), while the defined benefit plan distribution requirements are prescribed by Treasury Regulation 1.401(a)(9)-6.

The significance of these two sets of rules is that, when an IRA or other retirement account is *annuitized*, the value of the account and the associated payments *shift* from the defined contribution RMD rules under 1.401(a)(9)-5, to the lifetime pension requirements of 1.401(a)(9)-6. In other words, the value that is annuitized, and the payments themselves, are handled under -6 rules that are *entirely separate* from any other remaining -5 rules that otherwise apply to

defined contribution plan retirement account balances.

Fortunately, in practice retirees and their advisors don’t need to worry about the precise payment requirements under the -6 rules for retirement accounts that are annuitized, as the pension and immediate annuitization products offered in retirement accounts are designed by annuity carriers to qualify in the first place, and in practice it’s not possible to find a commercial annuity to buy that will violate the rules.

Generally speaking, though, the requirements for annuity and pension payments are fairly straightforward: payments must be based on the (reasonable estimate of) life expectancy of the account owner (or the joint and survivor life expectancy of the account owner and beneficiary); payments must either be level, increasing for inflation, or increasing at a fixed percentage that doesn’t exceed cost-of-living inflation adjustments; and the payouts may include a limited set of additional features like a period certain guarantee (as long as the guaranteed period doesn’t exceed the annuitant’s life expectancy anyway).

However, it’s important to recognize that when a retirement account is annuitized, the account balance and the subsequent payments are *entirely* segregated from any remaining retirement accounts and their associated RMD obligations. Which means *annuitized payments from a retirement account cannot be used to satisfy RMDs from the other non-annuitized accounts*.

Out and About

- Michael will be speaking on
“Advanced Roth Conversion Strategies”
for the IMCA Annual Conference
in San Diego, CA, on May 1st

- Michael will be presenting on the
“Future of Financial Planning in the Digital Age”
at the LPL Private Wealth conference
in Fort Lauderdale, FL on May 9th

- Michael will also be speaking for NAPFA National
in Seattle on May 18th on
“Strategies For Managing Sequence Of Return Risk”

Interested in booking Michael for your own conference or live training event? Contact him directly at speaking@kitces.com, see his calendar at www.kitces.com/schedule, or check out his list of available sessions at www.kitces.com/presentations.

Example 12. Sally has an IRA worth approximately \$300,000 that has a \$15,000 RMD due this year. Sally chooses to split the account and annuitize half (Part A) while continuing to keep the remainder invested (Part B). The annuitization of Part A will either produce payments of \$8,000/year (if annuitized for life), or \$11,000/year (if she chooses to annuitize for an even shorter fixed period of 15 years). Sally chooses the 15-year fixed annuitized period.

Given that Sally had her full \$300,000 account balance at the beginning of

the year, and was already subject to RMDs, she will still need to take the \$15,000 RMD this year, regardless of the fact that she annuitized some of the account and her remaining Part B balance is now only \$150,000. And her act of annuitizing part of her IRA doesn't change the calculation for this year (since the RMD obligation was already locked in at the beginning of the year).

However, in future years after the initial year, the accounts are treated as being entirely separate. Thus, next year, if Sally's Part B IRA rises in value and her RMD is \$9,000, she must still take the entire \$9,000 from that IRA, and cannot count any of the \$11,000 from the annuitized Part A towards her Part B RMD. This remains true even though Sally's RMD from Part A (without growth) would have only been \$7,500 as well, had she not annuitized the account; the "excess" \$3,500 from Part A still cannot count towards Part B after the initial year. The two remain entirely independent.

And if Sally had not already reached her Required Beginning Date at the time of annuitization, the RMDs for Part B would always be determined entirely separately from the start (without an RMD obligation in the first year), and the RMDs for Part A would always be satisfied simply by virtue of the fact that the annuity met the requirements to be a retirement-account-annuitized contract in the first place.

Coordinating RMDs With A (Qualified) Longevity Annuity Contract

The fundamental purpose of the Required Minimum Distribution rules is to ensure that tax-preferenced retirement accounts are *eventually* liquidated, so Uncle Sam can get his share. And because the only real goal is to ensure that the retirement account *is* liquidated, annuitization of an IRA isn't necessarily problematic – as long as the payments start by the required beginning date, and are made at least quickly enough to distribute money over the account owner's life expectancy. Which is exactly what normal annuitization does, and why it's not otherwise problematic to convert a retirement account into a lifetime retirement annuity.

Except in recent years, a new form of immediate annuity has begun to emerge. Various called a deferred immediate annuity or deferred income

annuity (DIA), or simply a "longevity annuity", the contract is similar to a traditional immediate annuity in that the purchaser hands over a lump sum check now, in return for receiving a stream of future payments (typically for life). The difference, however, is that while an immediate annuity has payments that begin immediately, a longevity annuity's payments may not begin until a distant future point in time.

Example 13. James is a 65-year-old, considering the purchase of a \$100,000 longevity annuity that stipulates payments for life, *beginning at age 85* (i.e., starting 20 years from now). Akin to an immediate annuity, all access to the account balance will be forfeited when James purchases the longevity annuity, and in the event that James passes away before age 85, all payments are lost (although some basic refund guarantees may be purchased as a separate rider).

However, if James lives to age 85, the longevity annuity will begin making payments of \$2,650/month (or \$31,800/year), a payout rate of nearly 32%/year. Of course, the first three payments will simply end out returning James' principal (as three years of \$31,800/year payments mostly just repay the original \$100,000 premium). However, beyond that point, James will continue to receive the \$31,800/year payments for life. Which means if he lives to age 100, the contract will pay out far more than a traditional immediate annuity (which would only pay about \$500/month or \$6,000/year for life for a 65-year-old), and have a superior internal rate of return in the long run.

In essence, the longevity annuity is designed to provide a highly magnified hedge against longevity risk – if the retiree actually lives beyond age 85, the longevity annuity provides a substantial 32%(!) payout rate to cover expenses in the later years. Of course, the caveat is that the payout is partially boosted by how long the retiree has to wait for payments to begin; nonetheless, even after accounting for the waiting period involved, the longevity annuity is still the equivalent of a fixed-income investment with a more-than-5% internal rate of return to age 100... which also beats out immediate annuity alternatives (as shown in Figure 7, next page). All of which is feasible thanks to the mortality credits that accrue from those who don't live to age 85. Of course, there's a risk that the retiree doesn't live until age 85 to get those payouts. But if that's the outcome, then the retiree probably didn't live long enough to risk outliving his/her money, either!

Unfortunately, though, there's a major problem with trying to hold a longevity annuity inside of a retirement account – as noted earlier, Treasury Regulation 1.401(a)(9)-6 does allow annuitization to cover a retirement account's Required Minimum Distribution obligations, but *only* if the payments occur at least quickly enough to spend down the account over the owner's life

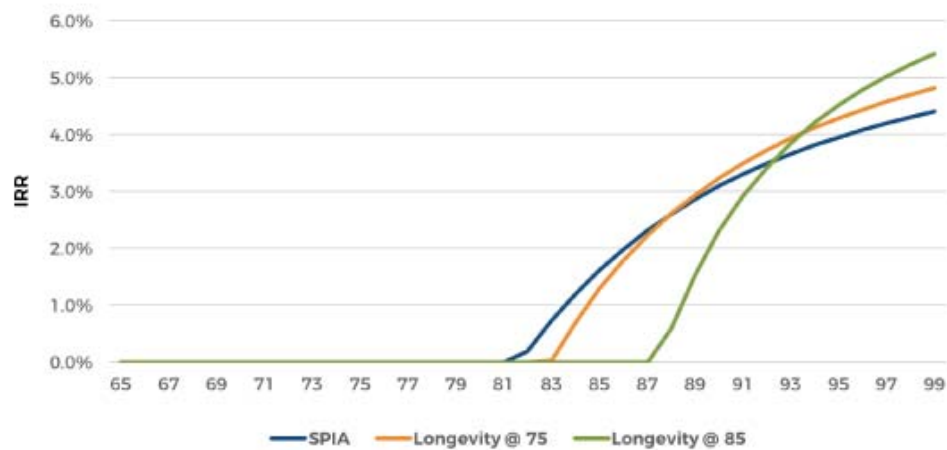
expectancy, beginning at age 70 ½. Except if a longevity annuity doesn't begin payments until age 85, it would potentially be permitting the account owner an extra 15 years of tax deferral before RMDs actually begin! Of course, the retiree could simply rely on the IRA aggregation rule to take RMDs from *another* retirement account, while also holding a longevity annuity... but if the other accounts are unwittingly liquidated too soon, the retiree could be stuck in a position where the only remaining retirement account asset is a longevity annuity, and the contract doesn't have any liquidity to pay RMDs before payouts begin at age 85!

Introducing The Qualified Longevity Annuity Contract (QLAC)

To address this conflict between the payout structure of a longevity annuity, and RMD obligations, the Treasury published proposed regulations in 2012 (finalized in 2014) to permit a longevity annuity to be used inside of a retirement account without running afoul of the RMD rules.

Specifically, Treasury Regulations 1.401(a)(9)-6, Q&A-17, and 1.408-8, Q&A-12, stipulate that a longevity annuity may be owned inside of a retirement account (including an IRA), and its payments (even when not beginning until age 85) will automatically satisfy the RMD obligation (in the same manner as any other annuitized payment under the -6 Regulations), as long as the annuity meets the

Figure 7. IRR Comparison Between Longevity And Immediate Annuities



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requirements to be a “Qualified Longevity Annuity Contract” (QLAC).

To qualify as a QLAC, the longevity annuity must:

- Begin payouts no later than age 85
- Provide only fixed payments (which may have a cost-of-living adjustment, but not be variable or equity-indexed)
- Have no cash surrender value once purchased (though a return-of-premium death benefit is still permissible)

In addition, the new rules placed a limit that no more than 25% of any employer retirement plan (and/or 25% of all pre-tax IRAs) can be invested into a QLAC, and in no case can the total dollar amount of QLAC purchases exceed \$125,000 (adjusted annually for inflation, but not yet increased above the original \$125,000 since the rules were issued in 2014). Thus, in practice, the QLAC limit is effectively 25% of retirement account balances up to a cap of \$500,000 of retirement accounts (at which point the hard dollar limit of \$125,000 would kick in).

Notably, as with other annuitized contracts purchased with retirement account dollars, the whole point of the QLAC rules is that the purchase of the QLAC, and its future payments, are automatically deemed to satisfy *that portion* of the retirement account's RMD obligations. But that doesn't change the requirement for any/all *other* retirement accounts to still make their own

RMD payments, regardless of the size and timing of the QLAC payment.

Example 14. Jeremy purchased a \$50,000 QLAC at age 65 that will begin payments of \$16,000/year at age 85. In addition, he has \$400,000 of other IRA assets. By age 70 ½, his IRA has grown to \$600,000, and he must begin to take RMDs from the account. His RMDs will be calculated only on the \$600,000 account balance, and not include any implied value from the \$50,000 QLAC purchase.

Moreover, when Jeremy turns 85 (and we'll assume his IRA is up to \$900,000 with future growth), he will begin to receive his \$16,000/year payments from the QLAC begin, he will *still* have to take RMDs from his \$900,000 IRA, and cannot count any of the \$16,000/year QLAC payments towards his IRA's RMD. The \$16,000/year payments from the QLAC itself will automatically (because the QLAC was qualified in the first place) be deemed to meet the RMD rules for (just) that annuity portion of Jeremy's retirement assets.

It's also important to note that the QLAC rules are only applicable to longevity annuities purchased inside of pre-tax retirement accounts. The QLAC rules and limitations do not apply to a longevity annuity purchased inside of a Roth IRA (because the account doesn't have an RMD obligation anyway). Nor do the QLAC rules apply for any purchases of non-qualified longevity annuities (i.e., contracts purchased with after-tax dollars from a taxable account). Thus, in the case of Roth or non-qualified longevity annuities, there are no limitations on the dollar amount of longevity annuities that can be purchased, nor on the timing of when payments begin, or the inclusion of other contract riders and benefits.

(Not) Using A QLAC To Defer RMD Obligations

While the QLAC rules permit a longevity annuity to be used inside of a retirement account without running afoul of the RMD obligation, the availability of a QLAC – with payments that can begin as late as age 85 – raises the question of whether it's desirable to purchase a QLAC as a proactive RMD deferral strategy. At least for up to 25% of the retiree's RMD

obligations (given that as much as 25% of retirement accounts can be allocated to a QLAC, up to the \$125,000 dollar limit).

But unfortunately, the answer appears to be “no”, at least not as a standard tax planning strategy. The reason is that in order to delay RMDs to age 85, the buyer of the QLAC must delay *payments* until age 85... with the risk that if he/she dies during the interim waiting period, all dollars are lost. Or in the event that a refund death benefit guarantee is purchased, *at least all growth* may be lost.

And the risk of loss is substantial, because as noted earlier it takes more than 3 years past when payments begin – approximately age 88 – *just for the longevity annuity buyer to recover his/her original principal*. Yet for a 69-year-old, who might be considering a QLAC purchase just before the onset of RMD obligations (at age 70 ½), *life expectancy is less than age 88*. In other words, using a QLAC to avoid RMDs has a *more-than-50%-chance of simply forfeiting all growth, or even the entire value of the QLAC, just trying to defer RMDs*. Especially since at best, the QLAC still only *defers* the RMDs; the payments beginning at age 85 will still be fully taxable (as IRA distributions), as will any payment of a death benefit guarantee (since it's still a payment from an IRA).

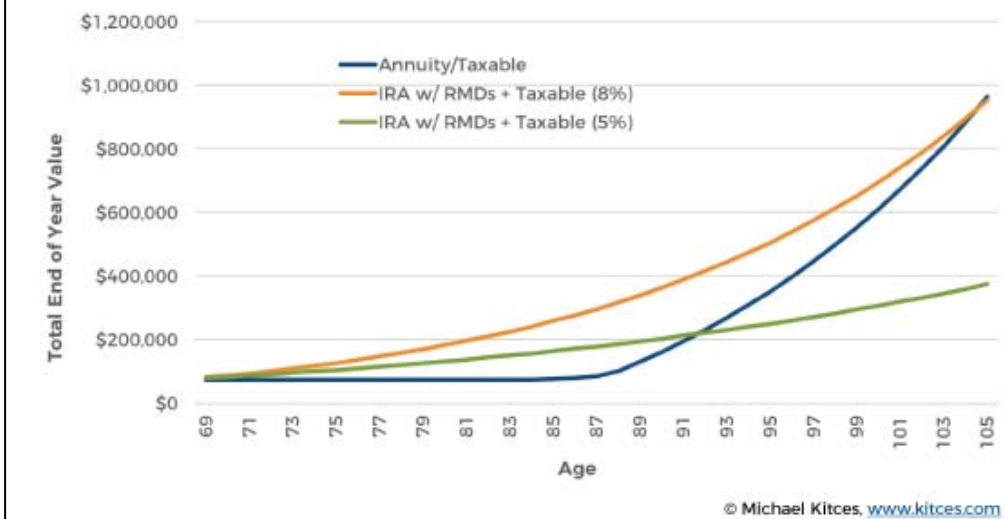
In fact, Figure 8 (top of next page) shows the value of a \$100,000 QLAC purchase (assuming it has a return-of-principal death benefit guarantee, so its “minimum” value will always be the original starting amount, less taxes), versus the value of a \$100,000 retirement account (e.g., a traditional IRA) that simply stays invested at 8% (assuming a growth-oriented portfolio if the retiree doesn't need the money anyway), where the retiree takes the RMDs as compelled to do so, and reinvests the proceeds in a taxable account. The RMDs are assumed to be taxed at 25% (and in order to evaluate comparable “after-tax” spendable wealth, any remaining pre-tax value of the QLAC or IRA is also haircut at 25% to ensure an apples-to-apples after-tax-wealth comparison). Growth on the funds already pushed into the taxable account (from RMDs that have occurred, or QLAC payments once they have occurred) are assumed to be taxed at 20% annually, a combination of taxing ordinary income interest and preferential long-term capital gains and qualified dividends.

As the chart reveals, using a QLAC to avoid RMDs is indeed a losing proposition for most. While the RMD payments may be delayed, the reality is that the QLAC still forces money out of the IRA as well, and in the later years does so *even faster than RMDs would have*. And in the meantime, the IRR on a QLAC is still “only” about 6% to age 100, while a

balanced account can potentially grow closer to 8%, which means the QLAC just lags further and further behind in the initial years. Accordingly, as the chart shows, *the retiree must live to age 105 for the QLAC to generate as much wealth as simply keeping the IRA, taking the RMDs, paying the taxes, and reinvesting the proceeds!* And even if the IRA “only” earns 5%, the breakeven age for using a QLAC to defer RMDs is still age 92 – which is well past life expectancy, and means using a QLAC to defer RMDs is a very against-the-odds bet.

In addition, for the retiree who ‘merely’ lives to life expectancy, the loss from using a QLAC to avoid RMDs is dramatic, even with a return-of-premium death benefit guarantee. By age 88 – when the QLAC buyer would still have done no more than recover \$100,000 of principal – the IRA would be up to almost \$160,000 (and could still be stretched by beneficiaries), *plus* the retiree would have almost \$140,000 in a non-IRA account

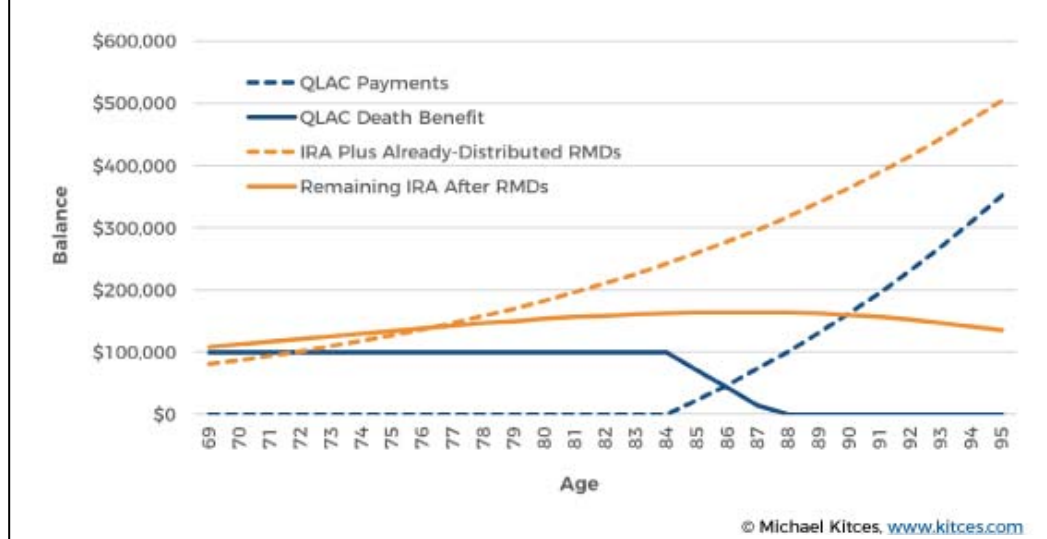
Figure 8. Comparing QLAC Vs IRA Taking RMDs At 5% & 8% Growth



representing the already-distributed (and already-taxed) RMDs. In other words, even if the retiree lives to life expectancy, using a QLAC to defer RMDs would have *cost* the retiree nearly 2/3rds of their retirement wealth in foregone growth, as shown in Figure 9 (below)!

Ultimately, this doesn’t necessarily mean that using a longevity annuity in general – or a QLAC in particular – is a “bad” deal. If the purpose of the longevity annuity is specifically for retirement cash flows to fund the later years of retirement – either for someone who is highly optimistic about their own life expectancy, or for whom the longevity annuity is simply appealing as a “longevity hedge” when done in conjunction with the

Figure 9. Remaining Wealth With QLAC Vs IRA Taking RMDs



rest of the portfolio – then the contract may be appealing. And if the contract is already appealing for retirement income purposes, there is certainly some value to purchasing it in an IRA as a QLAC, to also obtain some deferral of RMDs.

But if the goal is *just* to defer RMDs, the value proposition of the QLAC as a tax-deferral strategy isn't very compelling, as the retiree takes on a *significant* risk of losing out on almost two decades' worth of compounding growth just to defer RMDs, which in turn would represent a *substantial* loss, even for the retiree who lives to or slightly beyond life expectancy. The better outcome is simply to take the RMDs as necessary, and if they're really not needed for retirement spending, to simply reinvest the proceeds accordingly.



Planning Tip: Use a QLAC as a means to hedge against the impact of long life on a retirement portfolio, not simply as an RMD deferral strategy. If a longevity annuity is otherwise appealing as part of the retirement plan, it's beneficial to use retirement assets to buy a QLAC as a way to implement the longevity annuity. But the longevity annuity must be appealing on its merits first and foremost; otherwise, the retiree risks losing far more in foregone growth than can ever be gained in RMD deferral alone!

Understanding The True Impact Of Required Minimum Distributions

In a world where the key benefit of tax-preferenced retirement accounts is tax-deferred growth, the fundamental purpose of required minimum distributions is to limit the amount of tax deferral, and ensure that at *some* point, the retirement account begins to make distributions that are subjected to taxation... by *requiring* that a certain minimum amount be distributed (and taxed) every year past the specified age.

The key point, though, is that required minimum distributions don't *cause* taxes, just as using a pre-tax retirement account like an IRA doesn't *avoid* taxes. The reality is simply that tax-preferenced retirement accounts *defer* taxes to the future, while the RMD obligation *accelerates* that tax obligation to the present. In other words, it's not about *whether* taxes

will be paid. It's simply about *when*.

On the one hand, this key point is often forgotten by retirees themselves, who tend to view the presence of RMDs as a forced diminishment of wealth, as the IRA is compelled into making distributions, a portion of which is immediately ceded to Uncle Sam. Yet for a retiree subject to a 25% tax rate, it is inevitable that at *some* point, 25% of the account *will* be paid in taxes. Thus, a \$500,000 IRA is never really a \$500,000 IRA; it's a \$375,000 IRA, and a \$125,000 deferred tax liability. The net value doesn't change when the RMD occurs; it simply forces a release of (at least a portion of) the deferred tax obligation that was already present.

On the other hand, no one likes to pay taxes any sooner than they have to, and tax deferral does have at least *some* economic value, because of the opportunity to earn growth on those tax dollars before they're paid. Though ultimately, the lost tax deferral from RMDs is really quite small, primarily due to the fact that for most years, RMDs themselves are actually not very sizable relative to the total value of the account.

For instance, assume that Sheila has a \$1,000,000 IRA, and is just turning age 70 (and age 70 ½) this year. Sheila doesn't actually *need* the money in the IRA, and would have preferred to allow the tax-deferred compounding growth to continue as long as possible. But unfortunately, with the RMD obligation beginning this year, Sheila *must* begin taking distributions every year going forward.

Assuming a moderate growth portfolio earning 8% (as Sheila has already acknowledged that she doesn't want the RMDs, and doesn't need the money, and can still invest for growth), the chart below shows the percentage of the account that must be distributed every year as an RMD, and how much of the IRA is still remaining after the RMDs have occurred.

As the results show (top of next page), it's not until age 89 that the annual RMD percentage even exceeds the annual 8% growth rate, and by then the account is already up almost 60% from its original value! And it's not until Sheila is past age 100 that the IRA even falls back to its original balance at age 70 ½!

In addition, this illustration still doesn't show the value of the outside account that would be accumulating the RMDs, which is necessary to really do a fair comparison of the "cost" and actual adverse impact of losing tax deferral due to RMDs.

Figure 10. How RMDs Do (Not) Deplete The Value Of An IRA

IRA Distribution as % of Account	3.6%	3.8%	3.9%	4.0%	4.2%	4.4%	4.5%	4.7%	4.9%	5.1%
IRA Value	\$1,000,000	\$1,043,504	\$1,087,606	\$1,132,130	\$1,176,866	\$1,221,567	\$1,265,948	\$1,309,681	\$1,352,678	\$1,394,258
Age	70	71	72	73	74	75	76	77	78	79

IRA Distribution as % of Account	5.3%	5.6%	5.8%	6.1%	6.5%	6.8%	7.1%	7.5%	7.9%	8.3%
IRA Value	\$1,434,298	\$1,472,342	\$1,507,875	\$1,540,326	\$1,569,053	\$1,593,348	\$1,613,157	\$1,627,802	\$1,636,548	\$1,638,610
Age	80	81	82	83	84	85	86	87	88	89

IRA Distribution as % of Account	8.8%	9.3%	9.8%	10.4%	11.0%	11.6%	12.3%	13.2%	14.1%	14.9%
IRA Value	\$1,633,148	\$1,620,541	\$1,600,134	\$1,571,269	\$1,533,297	\$1,487,466	\$1,433,502	\$1,371,207	\$1,300,482	\$1,221,354
Age	90	91	92	93	94	95	96	97	98	99

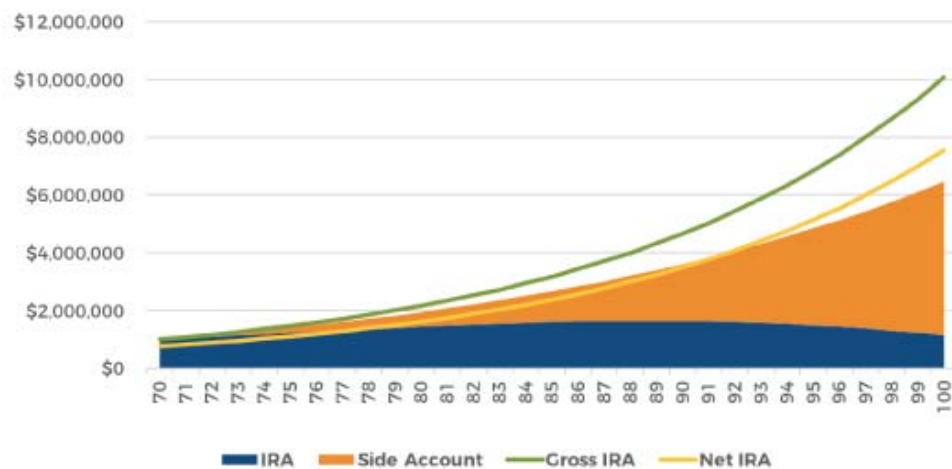
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Thus, continuing the earlier example, we can actually compare what the value of the IRA *would have been* if Sheila could have left the IRA intact, versus what actually happens as the assets are forced out of the retirement account, and into a taxable account, where they are subsequently taxed annually on growth thereafter. For now, assume Sheila pays a 25% marginal tax rate on IRA distributions (as all ordinary income), and a 20% marginal tax rate on the growth of the portfolio in the taxable account (as a combination of ordinary income tax rates on bonds, but preferential 15% tax rates on long-term capital gains and qualified dividends). Figure 11 shows the outcome over time, comparing Sheila’s net worth with the RMDs and side account, versus what the value of the IRA could have compounded to without RMDs (but still recognizing it will eventually be taxed at 25% anyway).

As the chart reveals, the actual *net* difference between the two scenarios is not *that* substantial. As noted earlier, this is primarily because the RMDs themselves are not a substantial portion of the account – with the first RMD amounting to only about 3.6% of the account balance.

In fact, in the early years, the RMD scenario is actually *ahead*, due to the fact that growth outside the IRA is taxable at “just” 20% (with preferential long-term capital gains and qualified dividend rates), while the growth inside the IRA is ultimately taxed at 25%. Eventually, tax-deferred growth (even at higher tax rates on IRA distributions) does overcome, but the value of avoiding RMDs is actually negative early on, and only modestly positive even in the later years. Or viewed another way, strategically managing the tax *rate* at which RMDs are made – e.g., by engaging in partial systematic Roth conversions in the early years to whittle down the size of the distributions – has far more positive impact potential than “just” trying to defer the RMDs themselves.

Figure 11. The (Limited) Value Of Deferring RMD Taxation



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Of course, ideally from an asset location perspective, the IRA would not hold assets that could have been taxed at more preferential tax rates in an outside account. For instance, instead of holding stocks that could grow at 8%, the IRA might hold bonds instead (taxed entirely at ordinary income rates either way). Yet holding bonds inside the IRA just lowers the growth rate on the

account, and further diminishes the benefits of delaying RMD taxation anyway, as Figure 12 illustrates (assuming a 3% bond yield).

In addition, the reality is that the entire “burden” of required minimum distributions is really only a burden on those who don’t actually *need* the assets to spend anyway. As shown above, RMDs only start out at 3.6% of the account balance – when at age 70, given the time horizon, a typical sustainable withdrawal rate would likely be closer to 4.5% - 5% or more. Which means retirees who are actually *using* their retirement accounts to fulfill their retirement *spending* needs are often withdrawing more than enough to cover their RMD obligations anyway.

Nonetheless, for a subset of retirement accumulators, the presence of RMDs really do force money out of the retirement account, earlier than it otherwise would have been withdrawn, and forfeiting some value of tax-deferred growth in the process. But as illustrated here, the net impact is actually far more modest than most retirees might realize!

Complying With And Planning For Required Minimum Distributions

In the end, the first burden of required minimum distributions is simply ensuring that the rules are complied with properly. Paying taxes on the IRA distribution when distributed is bad enough, but with the potential for a 50%(!) penalty tax for failing to

Figure 12. The Value Of Deferring RMD Taxation At Low(er) Growth Rates



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fulfill the RMD obligation, it is critical to ensure that RMDs are properly calculated, and that the withdrawals are properly timed and executed, especially around the potentially-confusing onset of the required beginning date.

And if a “mistake” does happen, the good news is that the IRS is often quite merciful about the otherwise draconian 50% penalty for failing to take an RMD. The key point, though, is not to hide or ignore a missed RMD once discovered, but to rectify it quickly, and report the situation (on Form 5329) with a hopefully-reasonable-cause explanation of why the RMD was missed in the first place.

Though beyond mere RMD compliance, there are further opportunities to more proactively plan around fulfilling the required minimum distribution obligation. This could include strategies like trying to further defer RMDs – for instance, by rolling IRA assets into a 401(k) plan for a not-more-than-5% owner who is still working, by converting to a Roth-style account that has no lifetime RMDs, or by maximizing the use RMDs (and minimizing the tax consequences) by using the RMD obligation to fulfill an already-planned (qualified) charitable distributions. And of course, there are still strategies like doing partial systematic Roth conversions in the earlier years, to whittle down the size of the pre-tax retirement account before the RMD phase is reached in the first place. Which also helps to avoid having large RMDs that drive up the retiree’s tax bracket in the later years as well.

In other cases, it's simply important to ensure that the RMD obligation is coordinated with the rest of the overall retirement distribution planning. Whether it's deciding *which* IRAs will be used to satisfy the RMDs (in situations where the RMD aggregation rule applies), or handling RMDs properly when annuities are being used (especially in the case of immediate and longevity annuities that have their own special rules). Yet as noted earlier, while annuities can in some cases help defer or minimize RMDs, it's still important to recognize that annuities should be bought first and foremost for the actual retirement income guarantees they provide – if they're relevant for that particular client and his/her goals – and not merely as an RMD avoidance (or really, deferral) strategy.

Of course, the reality is that for a substantial portion of retirees, the RMD rules are a moot point, because many retiree are *already* withdrawing more than enough to satisfy RMD obligations, simply by taking the withdrawals necessary to maintain their retirement lifestyles. After all, the RMD formula is intended to at least approximately replicate what a prudent retiree would likely be spending from a retirement portfolio anyway. In other words, for RMD planning to matter, the retiree has to actually not *need* the money in the first place. Or at least the retiree must have *some* other resources – for instance, other assets that can fund retirement spending, while the tax-deferred accounts grow and compound to the extent possible.

Nonetheless, for those who can afford to *not* take withdrawals from retirement accounts, managing and minimizing the RMD obligation to the extent permitted is highly appealing, allowing the accounts to grow on a tax-preferenced basis as long as possible. Though ultimately, even if the retirement accounts are not liquidated by spending or RMDs during life, the subsequent beneficiaries will face their own required minimum distribution obligations after the death of the original owner. Which will be discussed in a future issue of *The Kitces Report!*

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