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UNDERSTANDING REQUIRED MINIMUM DISTRIBUTIONS

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Understanding Required Minimum Distributions

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The idea behind Required Minimum Distributions, or RMDs, is that the government wants to give us a tax incentive to save for retirement, but they also want to make sure we don't misuse it. For example, if we're in the 24% tax bracket and we put money into a tax-deductible IRA or a 401(k), each dollar we put in only costs us 76 cents because it's a before-tax contribution. So, the government is helping us save, but the government also really wants this to be retirement money. In other words, they don't want it to be money that you never spend or leave for your heirs. Most importantly they want to make sure you pay tax on it eventually.

IRAs are one example of a use-specific plan, which the government loves. The 529 College Tuition Plan is another example. It's extremely tax-efficient for the investor if used for college, but extremely tax-inefficient if used for retirement. Similarly, IRAs are designed to encourage people to save money for retirement, and if the money is used for that purpose, then it's taxed in a friendly manner. If it's used for anything else, it's not.

The Longevity Challenge

The challenge for the IRS in providing this incentive for retirement savings has been the same challenge faced by the Social Security Administration in maintaining the system's solvency: people are living longer. Today, there is a 50% chance that the average 65-year-old American will live into their late 80s. The average couple aged 65 has a 50% chance that at least one spouse will live to age 92.[1] The IRS doesn't want to wait until your death to get its tax money because it might end up waiting a very long time. Thus, everyone is required to begin taking minimum distributions from their savings plans after age 73.

To the government's credit, it has lowered RMD percentage amounts in recent years because it recognized that increasing longevity rates were creating challenges from the other end as well, with some people legitimately worried about depleting their IRAs before they died. The bottom line is simply that the IRS doesn't want retirement income vehicles to be used as inheritance vehicles, so they require you to take minimum amounts of income from those vehicles each year once you've reached the required age.

When Do I Take RMDs?

The SECURE Act 2.0 was signed into law on December 29, 2022. The age when RMDs need to begin increases from age 72 to age 73 in 2023 and age 75 in 2033. The one exception to this is for someone still employed at age 73 at a business that they do not own. In that case, you do not have to take Required Minimum Distributions on that particular retirement plan. You still must take them on any other retirement plans, such as your IRA, but not on the plan that's with a company for which you are still employed at age 73.[2]

How Much Do I Take?

Here is basically how it works:

IRS Publication 590, which was updated in 2022 and remains the same for 2023, gives you a uniform table with a government-assumed life expectancy. Note that your government-assumed life expectancy is much longer than your statistical life expectancy:[3]

Uniform Lifetime Table					
Attained age	Distribution Period	Attained age	Distribution Period	Attained age	Distribution Period
72	27.4	89	12.9	105	4.6
73	26.5	90	12.2	106	4.3
74	25.5	91	11.5	107	4.1
75	24.6	92	10.8	108	3.9
76	23.7	93	10.1	109	3.7
77	22.9	94	9.5	110	3.5
78	22.0	95	8.9	111	3.4
79	21.1	96	8.4	112	3.3
80	20.2	97	7.8	113	3.1
81	19.4	98	7.3	114	3.0
82	18.5	99	6.8	115	2.9
83	17.7	100	6.4	116	2.8
84	16.8	101	6.0	117	2.7
85	16.0	102	5.6	118	2.5
86	15.2	103	5.2	119	2.3
87	14.4	104	4.9	120+	2.0
88	13.7				

To calculate your RMDs, take the balance of your IRAs on December 31 of the previous year and divide it by this life expectancy factor: At age 73, that RMD equals approximately 3.7% of your IRA balance and increases every year as you get older.

The good news is that, in addition to reducing RMD amounts in recent years, the government has also made it easier to calculate what you owe. While this process is simpler than it used to be, it's not totally easy. The uniform table formula above applies to unmarried IRA owners and owners whose spouses are not more than 10 years younger. A separate formula and a separate table exist for IRA owners whose spouses are more than 10 years younger, and generally, their RMDs end up being lower.

There are other complications as well. For instance, certain kinds of annuities have to be separated from the basic calculation, and those RMDs must be calculated differently. Specifically, these are annuities that are annuitized or must be annuitized at some point in the future. These particular instruments increase the dollar amount of your RMDs and therefore also increase the amount of taxes due on them.

Another complication is that if you have IRAs but also have any type of qualified plan, such as a 401(k), 403(b), or 457, the RMDs from the IRA and each of these plans must be calculated and made separately. They cannot be commingled. This is one of the major reasons (though not the only reason) that most people roll over their qualified plans into IRAs before age 73. It makes life simpler.

How Much Would I Owe for not Taking RMDs?

The current penalty for not taking sufficient RMDs each year by age 73 is 25%. That amount is down from the previous penalty of 50%. It's still a significant penalty, so it's important to do your calculations correctly.

What About Taxes?

The amount of extra tax liability you have because of your RMDs depends on many factors, including your personal situation and how much income you have from other sources. The key is to understand the concept of a marginal tax bracket. Under a marginal tax rate, the rate of tax increases as the amount of income earned increases. So, for the 2023 tax year (taxes due April 15, 2024), the federal tax brackets are[4]:

Tax Rate	Single	Married Filing Jointly	Married Filing Separately	Head of Household
10%	Up to $11,000	Up to $22,000	Up to $11,000	Up to $15,700
12%	$11,001 to $44,725	$22,001 to $89,450	$11,001 to $44,725	$15,701 to $59,850
22%	$44,726 to $95,375	$89,451 to $190,750	$44,726 to $95,375	$59,851 to $95,350
24%	$95,376 to $182,100	$190,751 to $364,200	$95,376 to $182,100	$95,351 to $182,100
32%	$182,101 to $231,250	$364,201 to $462,500	$182,101 to $231,250	$182,101 to $231,250
35%	$231,251 to $578,125	$462,501 to $693,750	$231,251 to $346,875	$231,251 to $578,100
37%	$578,1256 or more	$693,751 or more	$346,876 or more	$578,101 or more

However, even with all this information, there are still other factors to consider when it comes to RMDs. One of them is Social Security. Every extra dollar of taxable income generated from any source, including RMDs, might cause a greater part of your Social Security benefit to be taxed.[5]

Tax Filing Status	Provisional Income	Social Security Taxation
Single or Head of Household	Less than $25,000	0%
	$25,000-$34,000	Up to 50%
	More than $34,000	Up to 85%
Joint Filers	Less than $32,000	0%
	$32,000-$44,000	Up to 50%
	More than $44,000	Up to 85%

Don't Try This at Home

Whatever your situation may be, the most important thing for you to consider regarding RMDs (as well as Social Security) is whether your asset allocation is suitable and sufficient to generate the amount of minimum distributions you need to satisfy your requirements. It should be generating at least 3.7% in dividends or interest. If you're relying on capital gains each year for your RMDs, then, in essence, you're taking them from the principal, which is a slippery slope that you want to avoid.

While it is smart and advisable to use IRS Publication 590 and other available information and resources to estimate your RMDs, the process of creating a sound financial strategy that suits your needs and meets your retirement goals is best done with the help of a qualified professional financial advisor. And in today's economic climate, an advisor who specializes in the universe of income-generating financial strategies is uniquely qualified to help you devise a plan that satisfies your RMDs, maximizes your Social Security, and provides the kind of reliable income you need to meet your goals with confidence and peace of mind.

Source:

1. https://longevity.stanford.edu/understanding-longevity-an-important-life-planning-step/
2. https://www.cnbc.com/2022/12/23/secure-2point0-clears-congress-will-bring-changes-to-retirement-system.html
3. https://thelink.ascensus.com/articles/2022/1/19/your-search-for-the-new-life-expectancy-tables-is-over
4. https://www.forbes.com/sites/markkantrowitz/2022/11/22/new-2023-irs-income-tax-brackets-and-phase outs/?sh=3d67f50069d0
5. https://smartasset.com/retirement/is-social-security-income-taxable

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