

Required Minimum Distribution (RMD) Tips and Traps

- ▶ RMDs are a necessary evil for holders of tax-deferred retirement accounts.
- ▶ RMDs require a certain portion of your retirement balance to be withdrawn each year, depending on your age.

The tax-deferred compounding you get via an IRA or a company retirement plan enables you to grow your savings without having to fork over taxes on your investment earnings year in and year out. However, at some point, required minimum distributions, or RMDs, will take effect. All retirees must begin taking RMDs from their tax-deferred retirement plans by April 1st of the year following the year in which they turn age 70 1/2. They must then continue to take distributions by December 31st of each year thereafter. Roth IRAs aren't subject to RMDs. However, you exert more control than you might think over the timing of your RMDs, as well as over which accounts you tap. Here are some tips for getting the most out of your RMDs, as well as some traps to avoid.

Do

1. Even though you must calculate your RMD amounts for each of your traditional IRAs, you can draw your RMD from the investment that's most advantageous for you. If you've assessed your asset allocation and determined it's time to rebalance, take your RMD from the IRAs that hold assets where you need to lighten up.
2. Rather than taking your whole distribution at year-end, consider spacing your distributions throughout the calendar year to obtain a range of sale prices for your longer-term assets.
3. Consider "bucketing" your IRA and retirement-plan assets. That means dividing assets into cash or cash-like accounts to help address RMD and other income needs, intermediate-term assets (such as bonds) that are next in line for distributions, and long-term assets.
4. Put your distributions on autopilot to avoid the last-minute rush to execute trades (or worse, to avoid missing the deadline altogether). If you go the autopilot route, be sure to maintain cash assets in your accounts to avoid having your fund company or brokerage firm sell a long-term asset that you would have preferred to hold.

5. Coach elderly parents on taking their RMDs.

Don't

1. Miss the deadline. You'll owe a tax penalty equal to 50% of the distribution amount you should have taken but didn't, as well as the taxes that are due on any retirement-plan distribution.
2. Pay a tax penalty without stating your case first. The IRS' website indicates that the penalty will be waived if "the shortfall in distributions was due to reasonable error and that reasonable steps are being taken to remedy the shortfall." If you've missed a distribution or didn't take as much of an RMD as you should have, you'll need to fill out an IRS form. You'll also have to submit a letter detailing why you had a shortfall in your distribution and what you're doing to remedy it.
3. Spend your RMDs right away unless you've analyzed your retirement plan's viability and determined that you can afford to splurge.
4. Plow the proceeds into a Roth IRA without doing your homework first. You need to have enough earned income (generally, that means income from a job) to cover the amount of your IRA contribution. For example, if you want to contribute \$6,000 to a Roth, you'd need to have at least \$6,000 in earned income to do so. Unfortunately, income drawn from your retirement accounts doesn't count. Note that you can't make additional traditional IRA contributions after age 70 1/2.

Funds in a traditional IRA grow tax-deferred and are taxed at ordinary income tax rates when withdrawn. Contributions to a Roth IRA are not tax-deductible, but funds grow tax free, and can be withdrawn tax free if assets are held for five years. A 10% federal tax penalty may apply for withdrawals prior to age 59 1/2. Please consult with a financial or tax professional for advice specific to your situation.