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The Conundrum of Required Minimum IRA Distributions

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The traditional IRA mandates required minimum distributions (RMDs) to be satisfied each year by December 31st beginning at age 70½. The RMD rules were established to force those with retirement funds to withdraw some of these monies as taxable distributions while still alive rather than accumulating such funds and leaving them solely as an inheritance. One can always withdraw more than the minimum required amount, but withdrawing less than required subjects the IRA holder to steep penalties. Thus, with the amounts to be distributed determined by IRS code, what's less clear is the optimum timing to take RMDs.

Conventional wisdom suggests waiting until year-end to take your RMD given that income and capital gains grow tax deferred within the IRA account. However, there are several reasons not to wait until year-end to satisfy your required minimum distribution.

Under the current guidelines, the first RMD may be deferred until the calendar year following age 70½. If you do elect to wait until the following calendar year, you must take two distributions: one by April 1st and one by December 31st. This usually does not make sense given IRA distributions are taxed as ordinary income. However, deferring the first RMD may make sense if you expect to be in a higher tax bracket in the first year and lower thereafter even with the two distributions.

When considered as part of an overall budgeting process, the RMD can help fund your retirement lifestyle. If you depend on your RMD as a current source of retirement income, liquidating and distributing a portion each month to satisfy your annual RMD may make better sense than waiting until year-end.

Taxes due on an RMD are determined by the holder's income and deductions and the actual RMD amount is predicated on the prior year-end balance. Thus, while short-term gains will have little impact, a substantial market increase in the value of an IRA account may suggest a distribution is warranted regardless of the time of year. Let's say the market has had a nice run to the upside and your IRA account allocation has participated as well. The old adage, the devil you know is better than the one you don't know may apply and an early liquidation could make good sense.

Another reason not to wait until year-end to make the RMD is to enable you to dollar cost average your IRA distributions. This way if the market continues to perform well you are still in the game. No one can predict the market; investing takes time not timing, but dollar cost averaging can prove to be beneficial on the way in and on the way out of the market.

If you have a current need for cash, the RMD can prove a useful alternative to liquidating taxable accounts. For instance, let's say you had an immediate need for $100,000 in cash and your taxable (non-IRA) accounts hold highly appreciated or illiquid assets which would result in a long-term capital gain of $90,000 were you to liquidate the required $100,000. The capital gain would be approximately $18,000 assuming a long-term capital gains rate of 20%. Also, assume that your RMD for this year is $150,000. Although the RMD is taxed as ordinary income, you are required to take the distribution by year-end so taking the distribution now versus liquidating securities from your taxable account to fulfill the immediate obligation could be preferential.

Lastly, the qualified charitable distribution may be an under-utilized strategy for satisfying your required minimum IRA distribution. Assuming you are charitably inclined and have sufficient assets to maintain your lifestyle in retirement, you can gift up to a total of $100,000 to any one or several charities, thereby reducing your taxable income. In this scenario, assuming you only need an additional $100,000 for living expenses but need to take an RMD of $150,000 this year, you can distribute the excess $50,000 direct to a charitable organization. This may reduce your taxable income by $50,000 and assuming a marginal tax bracket of 35% a tax savings of approximately $17,500.

Making a decision about the distribution timing of an RMD is not always so simple: everyone's situation is different and the approaches may be different. When making such a decision, it is always best to consult with your trusted financial and tax advisor(s) to make the most appropriate plan. At Coastal Bridge Advisors, we are always here to assist and do our best to provide you with sound advice and guidance in these matters.