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Distributions from Retirement Accounts - How to Maximize Your Tax Break

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Tax-deferred retirement accounts such as IRAs, 401(k) and others offer potentially valuable tax savings and long term investment growth. However, when the government gives tax breaks with one hand it often takes something back with the other hand. In the case of retirement accounts, you have to be scrupulous about following the rules that govern withdrawals because the penalties for failure to comply can be severe. This article will review what you *can* do and what you *must* do with your retirement accounts, with the aim of allowing you to garner the maximum advantage of the tax deferral.

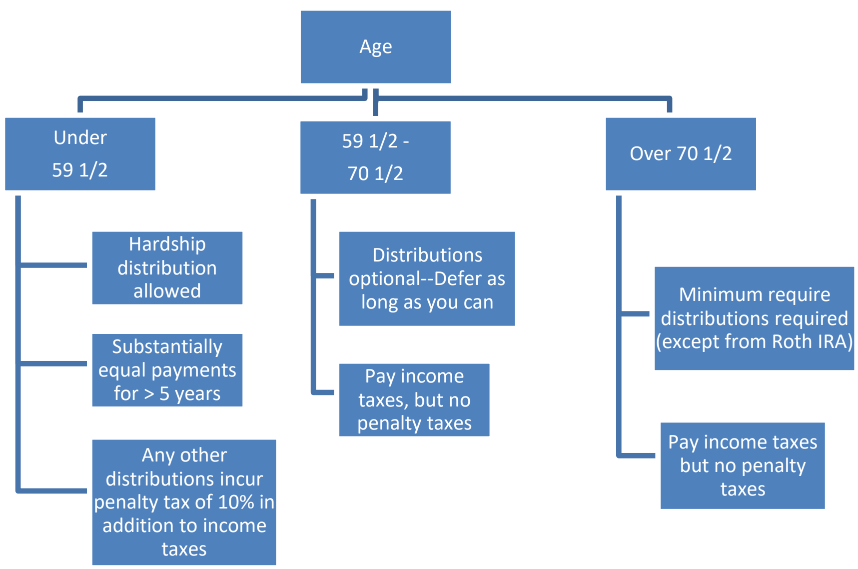
You can't defer taxes forever:
Requirements to withdraw from retirement accounts

The distributions you take from your retirement account depend on your age. The figure below summarizes which distributions are allowed, and which are required at different ages. This applies to your own retirement accounts (IRA, 401(k) etc.) or to IRA accounts you inherited from a spouse. IRA accounts inherited from anyone other than a spouse must follow different rules.

You should generally delay distributions as long as possible.

Since assets within a traditional IRA are not subject to income taxes until they are withdrawn, you should delay withdrawing as long as you can.[1] This effectively gives you an interest-free loan from the government on the amount you will ultimately owe in income taxes, which you can use to invest. Unlike the case with taxable investments where you have a very limited ability to deduct investment losses, every dollar lost in a traditional IRA at least reduces your tax liability proportionally.

All else being equal, you should withdraw from a Roth IRA only as a last resort. Unlike the case with a traditional IRA, any money you lose in a Roth comes entirely out of your own net worth.



[1] There is one possible exception for people in a low enough tax bracket where they may be able to reduce income taxes on their Social Security benefits. In this situation, IRA distributions might push your income high enough to ensnare your Social Security benefits. Potentially, low tax bracket taxpayers who deplete their IRA assets in years before they claim Social Security might have a lower lifetime tax bill. Taxpayers whose "combined income" (adjusted gross income plus tax-exempt interest plus half of Social Security benefits) exceeds $34,000 for single filers and $44,000 for joint filers are likely to have the maximum 85% of their Social Security benefits taxed.

Make sure you have named the right beneficiaries

You have the option of naming beneficiaries to your IRA accounts. If you neglect to do so, your estate will inherit the IRA and your heirs will lose potential tax benefits. Therefore, I strongly recommend that you name beneficiaries on each IRA account so that your intended heirs can get the maximum benefit.
If you do name a beneficiary (by completing paperwork that the financial institution with custody of your IRA will provide), that person will inherit your IRA regardless of what is in your will. So you should make sure that the beneficiaries you have named for your IRAs and retirement plans are consistent with the estate plan in your will.

Each IRA can have more than one beneficiary in the specified proportion (eg: 50% to spouse, 25% to child 1, 25% to child 2 etc.) If you prefer, an estate lawyer can set up a trust to be your IRA beneficiary. This could occur if you want a child to inherit your IRA assets, but not until reaching a certain age, for example.

Retirement plans such as 401(k)s have the spouse as beneficiary by default. You can name an alternate beneficiary only with both spouses' written authorization. If you do get divorced or if any of your intended beneficiaries passes away, make sure to update your beneficiary designations on your retirement plans and IRAs.

Distributions from traditional IRAs:
What is permitted, and what is required

You can take distributions from your traditional IRAs as early as age 59 ½ without paying any penalty tax. You still have to pay income tax on the distributions, however. There is no minimum required distribution before age 70 ½.

If you take a distribution too early, you not only pay income tax but also a penalty tax of 10% of the distribution!

(There are ways around this rule in some circumstances—see next section.)

For a traditional IRA or other retirement plans such as a SEP IRA where you took an income tax deduction for contributions you made to the account, you must begin taking distributions in the year in which you turn 70 ½. There is one exception: You can defer your first required distribution to April 1 of the year after you turn 70 1/2 if you want to double up the following year.

If you have a 401(k) plan or IRA and are still working past 70 ½, you might be able to defer taking required distribution until you retire if the plan allows it. Note that if you are at least a 5% owner of the business you must take required distributions starting at age 70 1/2 even though you may still be contributing to the account. It is important to keep good records of every required distribution you take because the penalties for failing to take enough are severe: 50% of the amount that you failed to distribute.

The fraction of your account that you are required to distribute to yourself depends on your age. That fraction is available on the IRS website (https://www.irs.gov/publications/p590b/) which contains a "uniform lifetime table." You use the account balance as of Dec. 31 of the year before to calculate the required distribution in the current year.

Note that once you are older than 59 ½ you can always take more than the minimum required. Every dollar you distribute is counted as ordinary income, regardless of the character of the underlying investment. For example, even if you have held a stock in your IRA for more than a year and sold shares to raise the cash to distribute, the distribution is still ordinary income.

Example of how to calculate your required IRA distribution:

You turn 78 in 2016. The balance of your IRA as of 12/31/2015 was $100,000.00. Looking in Table 3 ("Uniform Lifetime Table") in IRS Publication 590, you see that the "distribution period" for age 78 is 20.3 years.

So your required distribution for 2016 is 100,000 / 20.3 = $4,926.11. This can be taken any time during the year, or in multiple installments, as long as the total amount distributed by 12/31/2016 is at least the required amount.

How to get money out of your IRA or 401(k) before age 59 ½ without paying a penalty tax

You can begin withdrawing from your IRA before age 59 ½ if you commit to a series of "substantially equal" distributions. You use a life expectancy table or amortization method to calculate what fraction of your account to distribute. You must take that amount every year for at least five years or, if later, until you turn 59 ½. That means that if at age 56 you find yourself short of cash and want to dip into your IRA, you can do so but only in a prescribed amount and only if you also take distributions every year thereafter for the next five years.

You can take "substantially equal" distributions from your IRA. You can also take them from your 401(k), but only if you are no longer working at the business that sponsored the plan.

401(k) plans are allowed but not required to permit "hardship distributions" for expenses such as medical costs or to prevent eviction or foreclosure. These distributions do incur the usual income tax but not the penalty tax. If you are taking early distributions from your IRA to buy a first home or for higher education expenses, you can also avoid the penalty tax. You may also be able to take hardship distributions from your IRA.[2] Consult your tax advisor, be very careful, and keep good records and documentation.

Most Roth IRAs do not require you to make distributions

If you have saved in a Roth IRA (or other Roth account such as a Roth 401(k)), you do not have to take any distributions at all. Whatever distribution you do take is not taxed. The same is true if you inherited a Roth IRA your spouse. However, if you inherited a Roth IRA from anyone else, you have to take distributions according to the same schedule as if you inherited a traditional IRA. (See below.) Required distributions from an inherited Roth IRA are not subject to any income tax, although inherited Roth IRA accounts are subject to estate taxes if the estate is large enough.

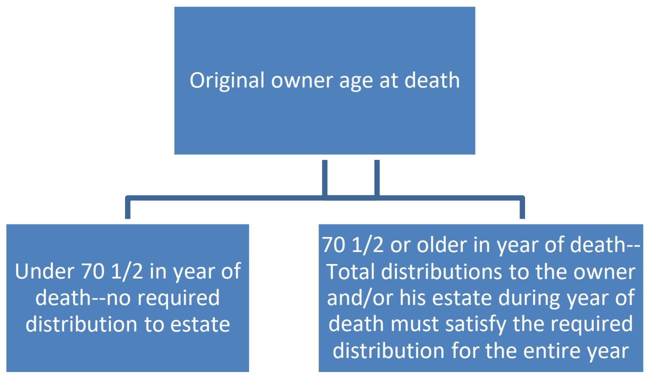
Required distributions from an IRA whose owner dies

The executor should determine whether the original IRA account owner took his/her required distributions before dying. If the original owner died before the year in which he/she would have turned 70 ½, there is no required distribution and therefore nothing to worry about. However, if the original owner dies during a year when they would have turned 70 ½ or older, that full year's required distribution must be taken before the end of the year.

[2] See IRS website https://www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-hardship-distributions.

If the owner took the distribution before death, no further action is needed. But if the required distribution was not taken before death, the estate must take enough to meet the requirement before the end of the year.

Inheriting an IRA from a spouse



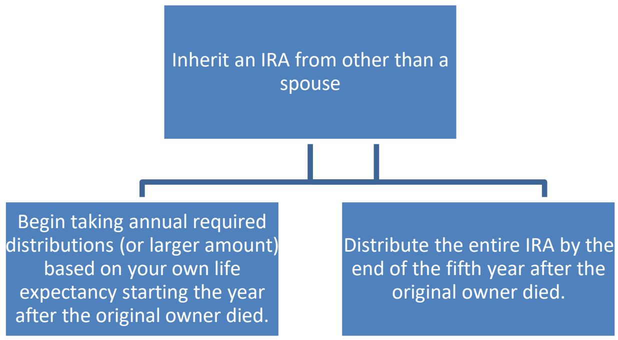
If you inherit an IRA from a spouse you can choose whether to treat it the same as your own IRA or whether to treat it as an IRA inherited from a non-spouse. In general, the surviving spouse should choose whichever of these options requires smaller distributions because that provides the greatest flexibility to minimize taxes. (You can always take more than the required distribution if you need the money, but if you have the choice of taking little or no distribution that will reduce your income tax.)

Most of the clients that I work with end up better off treating IRAs that they inherit from spouses as their own IRAs.

Here are two scenarios where someone might be better off inheriting an IRA from a spouse and treating it as an inherited IRA rather than as their own IRA:

- If the surviving widow/widower is under age 59 ½ but will need to take distributions from the inherited IRA. (If you inherit an IRA from a spouse and treat it as your own, distributions you take before you are 59 ½ will incur the penalty tax.)
- If an older spouse inherits an IRA from a younger spouse. Distributions from an IRA you inherit from a spouse but do not treat as your own must begin when the original owner would have reached age 70 ½, and after that are based on your (not the original owner's) life expectancy. In the case of inheriting from a younger

spouse, your required distributions might be deferred longer than if you treated the IRA as your own.



An excellent summary of options and required minimum distributions from inherited IRAs is available from Schwab. *(http://www.schwab.com/public/schwab/investing/retirement_and_planning/understanding_iras/inherited_ira/withdrawal_rules).*

Inheriting an IRA from other than a spouse

The diagram above summarizes the two options available to you when you inherit an IRA from someone other than a spouse: You can either distribute the entire IRA by the end of the fifth year after the original owner died (taking the money at any rate before that deadline), or you can start taking required annual minimum distributions by the end of the year after the owner died. I generally recommend starting to take IRA distributions by the year after the original owner dies because that will allow you to stretch out the distributions over the longest period of time, maximizing the benefits of tax deferral.

Note that the schedule of required distributions is different for an inherited IRA than for your own IRA. The required distributions from an inherited IRA are calculated using a table that the IRA maintains for "single life expectancy (for use by beneficiaries)." Compared to the uniform lifetime table, the rules for beneficiaries require larger minimum distributions. For example, a beneficiary at age 71 must take out 6.1% of the IRA (life expectancy of 16.3 years), whereas under the uniform lifetime table only 3.8% is required (life expectancy of 26.5 years).

You use the "single life expectancy table" only for the first year after you inherit the IRA. In subsequent years, you subtract one year from last year's life expectancy and use that to calculate the withdrawal. An example is shown in the chart below.

Example of how to calculate your RMD from an IRA inherited by a non-spouse:

You inherit an IRA from someone other than your spouse in 2016, the year you turn 50. You have two choices. First, you can distribute the entire IRA according to any schedule as long as the account is closed out by 12/31/2021.

However, in order to maximize the benefits of tax deferral, you can stretch out the distributions over more years if you take the first required distribution by 12/31/2017. Since 2017 is the year which you turn 51, you use age 51 and consult the "single life expectancy table".

You see that the life expenctency at age 51 is 33.3 years. So your required distribution by 12/31/2017 is the balance of the IRA on 12/31/2016 divided by 33.3.

Next year, you calculate your 2018 required distribution by dividing the 12/31/2017 balance of the inherited IRA by 32.3.

Conclusion:

It is important for you to select the proper strategy in dealing with your IRAs. Although there are exceptions discussed in the article, the general principles outlined in this article include:

- **Unless you inherited an IRA you should presume that you should not take any IRA distribution before you reach 59 ½.**
- **Unless you inherited an IRA you should presume that your best strategy is to wait until you turn 70 ½ to begin taking distributions.**
- **General guidelines for when you must begin taking distributions:**
    - **Age 70 ½ from your own IRA or from an IRA that you inherited from your spouse.**
    - **Year after original owner's death for inherited IRA from someone other than a spouse.**

Disclaimer: Signalert does not offer tax advice. We recommend that you consult with your investments, tax and/or legal advisors before acting on any recommendations in our Scoops.

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