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Required Minimum Distribution for IRAs

Don't get stuck paying a high tax on your IRA because you missed an important deadline. Make sure you keep up with important dates for withdrawals of the Required Minimum Distribution each year and other important (and changing) IRA-related tax laws.

If you are approaching the age of 70.5 years and have an Individual Retirement Account (IRA), it's a good time to get out a calendar and start planning for the distributions from the IRA. Generally, after becoming 70.5 years old, an IRA owner is required to make a minimum withdrawal annually. Missing the deadline for making a withdrawal of the Required Minimum Distribution (RMD) from an IRA incurs a 50% tax on the amount that should have been distributed.

If that unfortunate situation ever happens to you, the Internal Revenue Service (IRS) expects you to include Form 5329, "Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts," with your federal tax return and to pay the additional tax. The bank managing your IRA is required to send you a statement showing the RMD amount and the date that amount must be withdrawn or offer to calculate it. This will help you remember the deadline, but if the statement isn't sent, gets lost in the mail, or you simply forget to take the withdrawal, you might not avoid the penalty. There are possible avenues of relief to get out of paying the additional tax, but why get stuck in that mess? The bottom line is that the Internal Revenue Code (IRC) makes sure that the tax-deferred income eventually gets taxed.

There's an exception in the Code regarding the year-end distribution in the case of the first RMD. Specifically, an IRA owner is required to make the first RMD by April 1 of the calendar year following the calendar year the IRA owner becomes age 70.5 (Reg. §1.408-8, Q&A-3). In other words, if you become 70.5 years old on August 20, 2014, you're required to make the distribution no later than April 1, 2015. If you elect to delay the 2014 RMD until April 2015, however, you are still required to make the 2015 RMD by December 2015. Thus you include two distributions in your gross income in 2015 by delaying the first RMD.

The amount of the RMD depends on life expectancy of the IRA owner and the value of the IRA on December 31 of the calendar year immediately preceding the calendar year for which the RMD is to be made. For example, the 2014 RMD is based on your life expectancy in 2014 and the value of the IRA on December 31, 2013.

Special Regulations

Unlike other retirement plans, special rules apply to IRAs. First, the RMD is required when a taxpayer reaches 70.5 years old even if he or she continues to work. This isn't the case for other qualified retirement plans.

Second, the RMD is calculated for each IRA that the taxpayer owns. But the required minimum distribution doesn't apply to each IRA. Rather, the RMD is a total amount for the current tax year that the taxpayer can satisfy from whichever IRA(s) he or she chooses. The RMD also may be taken in a series of installments throughout the year as long as the total distributions are at least equal to the RMD. But there's no credit or carryover available for future years if more than the RMD for any past year was distributed to the IRA owner. Each tax year is independent.

Let's suppose that you want to do some tax planning to avoid the RMD or to reduce the current tax effect by having the RMD distributed directly to a charity. When the law allows it, the distribution isn't reported as gross income on the tax return. Thus you reduce the adjusted gross income (AGI) and any computations associated with the AGI. There's no question that this area of the tax law has tax hazards that need to be navigated carefully.

A popular provision called the Qualified Charitable Distribution (QCD), which allows a distribution of up to $100,000 to a charitable organization (IRC §170(b)(1)(A)), has been available off and on since 2006 and was even put back into the tax law retroactively. The provision, however, is not available for 2014. Currently, the tax law states that qualified charitable distributions "shall not apply to distributions made in taxable years beginning after December 31, 2013," per IRC §408(d)(8)(F). Because the QCD is considered a distribution from an IRA, the RMD was reduced or eliminated by the QCD for the IRA owner. In essence, it allowed taxpayers to make the IRA distribution and get a 100% tax deduction without treating the distribution as taxable, itemizing the charitable deduction on their Schedule A where it would have had a less favorable tax effect. As the law stands now, IRA owners can't donate their RMD to a charitable organization to avoid being taxed on their IRA. Any donation at this moment will require the taxpayer to report the distribution as taxable, and then he or she would have to deduct the charitable contribution with the itemized deductions. The QCD provision may become available again and should be monitored.

Other Issues to Look For

In some cases, an IRA owner may elect to roll over all or part of an IRA to another IRA. It's common knowledge that rollovers per the 60-day rule generally aren't taxable as long as the full amount is deposited to the same or another IRA within 60 days. But the RMD amount can't be rolled over because it's still required to be distributed. IRA owners might think that they're getting around the RMD rules, but the tax law specifically states that the amount of the RMD needs to be carved out of the distribution and treated as taxable income. Per Regulation §1.408-8, Q&A-4, "The portion of a distribution that is a required minimum distribution from an IRA…[is] not eligible for rollover."

As previously noted, the RMD doesn't need to be satisfied by each IRA. Instead, it may be satisfied by a distribution from any IRA. This rule sounds simple to follow for IRA owners and their financial institution, but this could easily go wrong in practice if the IRA owner isn't tracking RMD rules. If IRA funds are taken from one bank and then deposited into another bank using the 60-day rule, the former bank may only view the distribution as satisfying the RMD if it was large enough. The receiving bank will more than likely not consider the RMD since it has no knowledge of the value of the IRA in December of the prior year. As a result, the taxpayer may not be notified that an RMD amount is needed or may have attempted the rollover in an effort to avoid the RMD for that year. The net result is that the taxpayer may end up being charged a 50% tax on the RMD amount plus penalties and interest as a result of the IRS inquiry of the missing RMD, IRA rollover, or, worse yet, a future IRS audit.

Another important area of the tax code is the ability of an IRA owner to convert part or all of his or her IRA into a Roth IRA. Such a conversion does reduce the RMD amounts in the future because RMDs aren't required by a Roth IRA. But the taxpayer must again be cautious. Once the taxpayer is required to take an RMD, it can only be converted to non-RMD amounts for the current year. As previously noted, if the taxpayer has multiple IRAs, the RMD is computed on each IRA prior to any conversion, and the RMD amount can be made from any of the IRAs. It isn't likely that taxpayers or clients notice when they turn 70.5 years old, and when they do or are about to, they probably won't readily communicate it. So for your own IRA and for those that provide tax advice, it proves valuable to keep track of your birthdate for the RMD along with other tax laws that are age sensitive. **SF**

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