

AI-01710 RMD Explained and Protocols

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What is RMD? Explain and deep dive. What are the reasons RMD was created? List 22 protocols to reduce or soft-land RMD.

Let's break down Required Minimum Distributions (RMDs) in detail.

What is RMD? Explain and Deep Dive.

Required Minimum Distributions (RMDs) are the minimum amounts that you must withdraw annually from most employer-sponsored retirement plans (like 401(k)s, 403(b)s, and 457(b)s) and individual retirement accounts (IRAs, including Traditional, SEP, and SIMPLE IRAs). Roth IRAs are generally exempt from RMDs during the original owner's lifetime.

The purpose of RMDs is to ensure that the government eventually collects taxes on the tax-deferred growth of these retirement accounts. Since contributions to these accounts (and their earnings) have not been taxed yet, the IRS requires you to start taking distributions and pay income tax on them once you reach a certain age.

Key Aspects of RMDs:

- **Starting Age:** The age at which you must begin taking RMDs has changed over time. Currently, for those who turn 73 in 2023 or later, the RMD age is 73. For those born in 1960 or later, it will eventually increase to 75.
- **Deadline:** Your first RMD must be taken by April 1st of the year following the year you reach the RMD age. For subsequent years, RMDs must be taken by December 31st of each year.

- **Calculation:** The RMD amount is calculated by dividing the account balance as of December 31st of the previous year by a "life expectancy factor" provided by the IRS in their Publication 590-B. As you get older, the life expectancy factor decreases, which generally means your RMD amount (as a percentage of your balance) will increase.

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- **Multiple Accounts:** If you have multiple traditional IRAs, you calculate the RMD for each, but you can withdraw the total RMD amount from any one or combination of those IRAs. However, RMDs from 401(k)s and other employer-sponsored plans must be taken from that specific plan.
- **Penalty for Non-Compliance:** Failing to take your RMD on time or taking less than the required amount can result in a significant penalty. The penalty is 25% of the amount not distributed, though it can be reduced to 10% if corrected in a timely manner.
- **Taxable Income:** RMDs from pre-tax retirement accounts are considered ordinary income and are subject to federal income tax (and potentially state income tax).
- **Inherited IRAs:** RMD rules also apply to inherited IRAs, with specific rules depending on the relationship to the deceased account owner (spouse, minor child, disabled/chronically ill individual, or other beneficiaries).

What are the Reasons RMD was Created?

RMDs were created primarily for two main reasons:

1. **To Collect Tax Revenue:** Retirement accounts like Traditional IRAs and 401(k)s offer significant tax advantages: contributions are often tax-deductible, and the money grows tax-deferred for many years. The government allows this deferral, but eventually, it wants to collect its share of taxes. RMDs ensure that this tax revenue is eventually realized. Without RMDs, individuals could potentially keep money growing tax-free indefinitely, or pass it on to heirs without it ever being taxed as income.
2. **To Prevent Retirement Accounts from Being Used as Permanent Wealth Transfer Vehicles:** While retirement accounts are designed to provide income

during retirement, without RMDs, they could be used more effectively as estate planning tools to transfer wealth to beneficiaries without ever incurring income tax. RMDs force the distribution of these funds, ensuring that a portion of the wealth is subject to taxation before it can be fully passed on.

Essentially, RMDs strike a balance between encouraging retirement savings through tax incentives and ensuring that the government ultimately collects the deferred tax revenue.

22 Protocols to Reduce or Soft-Land RMD

While you can't entirely avoid RMDs (unless you have a Roth IRA as the original owner), there are many strategies to manage them effectively, potentially reducing their tax impact or mitigating their effects on your financial plan. Here are 22 protocols:

1. **Roth IRA Conversions (Strategic Roth Conversions):** This is one of the most powerful strategies. By converting pre-tax IRA/401(k) funds to a Roth IRA *before* RMDs begin, you pay taxes on the conversion amount now, but future qualified withdrawals from the Roth IRA (including what would have been RMDs) are tax-free. This removes those converted funds from your RMD calculation entirely.
2. **Qualified Charitable Distributions (QCDs):** If you are age 70.5 or older, you can direct up to \$105,000 (2024 limit, indexed for inflation) directly from your IRA to a qualified charity. This amount counts towards your RMD but is excluded from your taxable income. It's an excellent way to satisfy your RMD while supporting causes you care about and reducing your adjusted gross income (AGI).
3. **Withdraw Strategically Before RMD Age ("Early RMDs"):** If you retire before RMD age and anticipate being in a lower tax bracket in your early retirement years, consider taking larger withdrawals from your tax-deferred accounts before RMDs are required. This can reduce your account balance, leading to lower RMDs later when you might be in a higher tax bracket.
4. **Delay Social Security Benefits:** By withdrawing from your retirement accounts in your early retirement years, you might be able to delay claiming Social Security benefits. Delaying Social Security up to age 70 can significantly

increase your monthly benefit, providing a larger, more stable income stream later when RMDs are larger.

5. **Qualified Longevity Annuity Contract (QLAC):** You can use a portion of your IRA or 401(k) to purchase a QLAC. The money invested in a QLAC is excluded from your RMD calculation until payments begin, which can be as late as age 85. This can reduce your current RMDs and provide guaranteed income later in life.
6. **Continue Working (for Current Employer's Plan):** If you are still employed at age 73 (or older) and are not a 5% owner of the business, you can often delay RMDs from your current employer's 401(k) plan until you retire. This exception generally does not apply to IRAs or 401(k)s from previous employers.
7. **Reverse Rollover:** If you have an IRA and are still working, and your current employer's 401(k) plan allows it, you may be able to roll your IRA money *into* your current 401(k). This can effectively delay RMDs on those funds until you retire, assuming the "still working" exception applies.
8. **Strategic Asset Location:** Place assets that are expected to grow significantly in Roth accounts (which have no RMDs for the owner) or taxable accounts. Assets with lower growth potential or those you plan to spend sooner can remain in tax-deferred accounts.
9. **Harvest Tax Losses:** If you have investments in taxable accounts that have lost value, you can sell them to realize capital losses. These losses can offset capital gains and up to \$3,000 of ordinary income annually, which can help offset the tax impact of your RMDs.
10. **Manage Tax Brackets Annually:** Be mindful of your overall income each year, including RMDs, to stay within desired tax brackets. You might adjust other income sources or deductions to minimize the tax impact of your RMDs.
11. **Consider In-Kind Distributions:** Instead of selling investments to meet your RMD, you can sometimes transfer investments "in-kind" from your retirement account to a taxable brokerage account. This avoids selling assets when prices are low and allows them to recover in a taxable account. However, the fair market value of the transferred assets at the time of distribution is still taxable.

12. **Aggregate IRA RMDs:** While you must calculate RMDs for each traditional IRA separately, you can take the total RMD amount from any one or combination of your traditional IRAs. This flexibility allows you to draw from the IRA with the most cash, or from an account you wish to liquidate.
13. **Review Beneficiary Designations:** For inherited IRAs, the beneficiary's type (spouse, eligible designated beneficiary, or non-eligible designated beneficiary) significantly impacts RMD rules. Ensure your beneficiary designations align with your estate planning goals and RMD management strategies for your heirs.
14. **Use a Retirement Planning Software/Advisor:** Utilize specialized software or work with a financial advisor to project future RMDs and model various withdrawal strategies to minimize their tax impact over your lifetime.
15. **Pre-Retirement Income Smoothing:** If you anticipate a "taxable income valley" between early retirement and the start of RMDs (and Social Security), consider pulling more from tax-deferred accounts during this lower-income period to smooth out your future tax burden.
16. **Charitable Remainder Trusts (CRTs):** For very large retirement accounts and significant charitable intent, you could potentially transfer IRA assets to a Charitable Remainder Trust. This can avoid immediate taxation on the RMDs, provide an income stream for you, and eventually benefit a charity. This is a complex strategy and requires professional guidance.
17. **Health Savings Account (HSA) Use:** If you have a high-deductible health plan and an HSA, these accounts grow tax-free and qualified withdrawals for medical expenses are tax-free. There are no RMDs for HSAs, making them a powerful tool for tax-free growth and distributions, especially in retirement when healthcare costs are high.
18. **Delay Taxable Investments:** Prioritize investing in tax-advantaged accounts (like 401(k)s and IRAs) first to maximize tax deferral. Once you've maxed those out, consider taxable accounts, but be aware of capital gains and dividends.
19. **Plan for Spousal Beneficiaries:** If your spouse is your sole primary beneficiary, they have special options upon inheriting your IRA, including treating it as their own (potentially delaying RMDs until their own RMD age) or rolling it into their own IRA. This can provide significant flexibility.

20. **Consider Annuities (Non-QLAC):** While QLACs specifically address RMDs, other types of annuities can provide guaranteed income streams. By structuring your retirement income, you might be less reliant on drawing large amounts from your IRA for living expenses, making RMDs more manageable.
21. **Review Investment Holdings:** Before taking RMDs, review your investment portfolio. If you have assets that have performed poorly, you might choose to take your RMD from those specific assets (if allowed by your custodian) to realize losses and reduce the account balance for future RMD calculations, although this must be carefully considered for tax implications.
22. **Automate Withdrawals:** Set up automated RMD withdrawals with your financial institution to avoid missing the deadline and incurring penalties. While this doesn't reduce the RMD itself, it ensures compliance and peace of mind.

It's crucial to consult with a qualified financial advisor and tax professional to determine the best strategies for your specific financial situation, as RMD rules and tax laws can be complex and change over time.