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August 7, 2016

Some pitfalls to avoid when taking required distributions from retirement

The Baby Boomers are in the news again as the oldest of them turn 70 years old in 2016. Besides being surprised that they are septuagenarians, some may also be in the dark about the expectation of the IRS to start cashing in those retirement savings that took decades to build up. ElderLaw Answers recently posted a newsletter article on "Avoiding Pitfalls When Forced to Start Breaking Your Retirement Piggy Bank."

The rules about retirement plans were created by Congress to encourage saving for retirement during the plan owner's working years. The assets in these plans build up tax-free, including earnings, investment income and gains. Then when the plan owner starts making withdrawals, the funds withdrawn are treated as taxable income in the year the distribution is made. This is also true if you give your children or someone else the retirement plan at your death and they make withdrawals, they will then pay the tax at their income tax rates. The rules regarding required minimum distributions (RMDs) arose out of the same laws that created Individual Retirement Accounts (IRAs), 401ks, and other such qualified plans for retirement savings. It is important for those turning 70 years old to learn the rules on RMDs to structure distributions properly to avoid significant tax consequences and even more significant penalties.

The first decision is when to begin taking RMDs, if your situation requires that you do so. Usually, the RMD must be taken by December 31 each year. However, the IRS gives a grace period to newly minted 70 year olds. They can defer the first RMD until April 1 of the year following when they turn 70½. Therefore, if you turn 70 in the first half of 2016, you must make your withdrawal by April 1 of 2017. On the other hand, if you turn 70 in the second half of 2016, you will not be 70½ until 2017 and can wait until April 1, 2018 to make withdrawals. This might seem like a bonus, but consider that if you wait until April 1, 2018 in this example, you will need to make a *second* withdrawal by December 31, 2018. Depending upon the size of your RMD each time, this might result in a much higher tax bracket for that year and could affect taxes on your Social Security or increase your Medicare Part B and Part D premiums that are based upon income. So it is important to time your withdrawals carefully. There is a potential 50 percent penalty on what should have been withdrawn but was not.

Your plan administrator should be able to help you determine your RMD but it is still good to have some idea how the amount is calculated. All tax-advantaged plans with a required minimum distribution determine the RMD by dividing the fair market value of the retirement account(s) by the applicable distribution period (based on age). For example, $100,000 in a retirement account of a 73 year old as of December 31, 2015, would result in a RMD of $4,049 by December 31, 2016 ($100,000 divided by the distribution period of 24.7 years).

There are additional rules for employees who are still working, those with much younger spouses, and for Qualifying Longevity Annuity Contracts. If you miss a required withdrawal or under withdrew, you can ask to have the penalty waived by filing Form 5329 with the IRS. There are also opportunities to make qualified charitable contributions. Planning is key; therefore, before you reach the age of RMDs, it is good to research and consult with knowledgeable advisors.