

## REQUIRED MINIMUM DISTRIBUTIONS (RMDs)

# How to Downsize Your RMDs

You must start taking required minimum distributions from your IRA at age 70½. But you can reduce the tax bill.



Illustration by Ileana Soon

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After you've spent decades diverting a healthy stash of cash to your tax-advantaged retirement accounts, you need to start withdrawing a chunk of it each year once you turn 70½. But if you're fortunate enough to be living comfortably off a pension, **Social Security** or other savings, the income from your **required minimum distribution**—and the tax bill that follows—may be more hindrance than help.

Your RMDs are based on the balance in your accounts as of December 31 of the previous year, divided by a life expectancy factor based on your age. Most people use the Uniform Lifetime table, Table III, in Appendix B of **IRS Publication 590-B**, available at [irs.gov](https://www.irs.gov). The deadline to take your annual RMD is usually December 31, but you have until April 1 of the year after you turn 70½ to take your first required withdrawal. (The Secure Act, currently pending in Congress, would increase the starting age to 72 for RMDs from retirement accounts.) You'll pay a hefty penalty—50% of the amount you should have withdrawn—if you forgo or delay your RMD past the deadline.

Bob Hite, of Asheville, N.C., turned 70 in May. Thanks to the pension he receives from his career as a petroleum engineer and Social Security benefits for him and his wife, Jane, the couple doesn't need income from the RMD he will withdraw from his traditional IRA in November. (Jane is still two years away from taking her first RMD.) After discussing strategies with Ann Gugle, a certified financial planner in Charlotte, N.C., they plan to shift some of their charitable donations from their donor-advised fund to money from his IRA, using qualified charitable distributions (keep reading for details on how these work). They might also convert the remainder of his IRA to a Roth over the next several years. They'll have to pay taxes on the money they convert, but once it's in a Roth, it will grow tax-free and won't be subject to RMDs.

Your needs will likely evolve in your seventies, eighties and beyond, and your strategies will change, too. As the end of the year approaches, it's a good time to withdraw your 2019 RMD (if you haven't already) and start planning how to handle distributions in 2020 and beyond.

## Send it straight to charity

If charitable giving is a regular habit, a qualified charitable distribution, or QCD, is a **tax-efficient** way to meet your philanthropic goals. Those 70½ or older can transfer up to \$100,000 from a traditional IRA to charity tax-free each year, which will count as your RMD without being added to your adjusted gross income. Your charitable gift won't be taxed, as it would be if you were to take a distribution and then donate the cash to charity. The donation isn't deductible, but it will lower your modified adjusted gross income, which could help you avoid the high-income surcharge for Medicare parts B and D, as well as lower the percentage of your Social Security benefits that is subject to taxes.

John Bohnsack, a CFP in College Station, Texas, says that between his mother's pension and the income his father draws from renting out his farm in Hillsboro, N.D., his parents earn more than when they were working, and their tax liability is increasing each year. His father, Brian, made his first QCD in 2018 as a way to give to his church without being taxed on the money as it went in or came out of his IRA.

With a QCD, the money needs to go directly from your IRA to the charity (or charities) that you select. Check with your IRA administrator about the procedure; you may need to use a distribution form, or you may be able to write a check from your IRA to the

organization.

A QCD can't be a last-minute decision in the calendar year. If you take your RMD before planning for the QCD, it's too late for it to satisfy the required withdrawal. Mark Wilson, a CFP and president of Mile Wealth Management in Irvine, Calif., recommends completing the task by November, before your IRA custodian gets inundated with end-of-year requests.

Reporting your QCD correctly on your tax return is critical. Your IRA administrator will report the amount of money that was distributed on Form 1099-R, but the form doesn't specify whether it was a withdrawal or a tax-free transfer to a charity. When filing your tax return, report the total distribution on line 4a of your Form 1040. Then subtract any portion that was a QCD and report the remaining amount on line 4b, writing "QCD" to explain why part of the distribution isn't taxable. If you gave your full RMD to charity and didn't have other distributions, you'd write \$0 on line 4b and QCD next to it. Tax software should walk you through this; if you use a tax preparer, make sure he or she knows you did a QCD. Keep the records of the charitable transfer in case the IRS asks about the difference.

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Despite its advantages, a QCD is not a catch-all solution for the charitably inclined. For one thing, you can't stash your QCD in a donor-advised fund, if that is your preferred way to give. It's wise to discuss your options and crunch the numbers with your financial planner.

## Reinvest the money

After you withdraw money from your IRA, if you invest it in tax-efficient securities in a taxable account, your money can continue to grow without generating a lot of taxes.

Municipal bonds, which are issued by state and local governments and related agencies to finance general operations or public projects, produce competitive yields and tend to hold their own during tumultuous times. Their interest is generally exempt from federal income taxes, and interest from bonds issued in an investor's home state is usually exempt from state income taxes, too. **Fidelity Intermediate Municipal Income** (symbol **FLTIX**), a member of the **Kiplinger 25**—the list of our favorite no-load funds—focuses on intermediate-term bonds with dependable returns. The fund yields 1.3%, or a tax-equivalent yield of about 2.2% for those in the highest income tax bracket of 37%. Exchange-traded funds are another tax-efficient option. Because they don't always have to sell holdings when investors cash out, they don't distribute a lot of capital gains. (For a list of *Kiplinger's* favorite ETFs, see [kiplinger.com/links/etf20](https://www.kiplinger.com/links/etf20).)

## Pay your estimated taxes

Once you retire, you'll probably need to start making estimated tax payments four times a year. People living on retirement income can under-withhold because federal and state taxes aren't typically withheld from dividends and Social Security, says Kathleen Schnelle, a tax specialist at Truepoint Wealth Counsel. If you pay at least 90% of what you owe for the year, or 100% of what you owed for the previous year (110% if your AGI exceeded \$150,000), you will be protected from an underpayment penalty.

To simplify the process, many taxpayers divide the previous year's tax bill by four and send 25% on each payment deadline. But depending on the source of your retirement income, you may be able to satisfy the IRS by having taxes withheld from that income.

For IRA distributions, the IRS requires that 10% be withheld unless you tell the custodian otherwise. If you don't need your RMD, wait until December to take it and ask the sponsor to withhold a large enough portion to cover your estimated tax on the IRA payout and all of your other taxable income for the year, assuming your RMD is large enough to cover your entire tax bill.

Although estimated tax payments are supposed to be paid every quarter, amounts withheld from the IRA distributions are considered paid evenly throughout the year, even if you make them in a lump sum payment at year-end. This saves you the hassle of making quarterly estimated payments and can help you avoid getting hit with underpayment penalties.

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Another advantage to this strategy: By waiting until later in the year to take the RMD, you'll have a better estimate of your actual tax bill and can fine-tune how much to withhold.

## Help your grandchild pay for college

Using your distribution to open and fund a **529 plan** for your grandchild's college education costs can net you a state income tax deduction, depending on your state. (Most states that offer a tax break let any resident who contributes to a 529 take the deduction, but some limit the tax break to the account owner.) The deduction won't eliminate your tax bill, but it could reduce it, says Paul Winter, a CFP and president of Five Seasons Financial Planning in Salt Lake City.

However, your 529 plan could negatively impact your grandchild's financial aid eligibility. Money in a grandparent-owned 529 account is not reported as an asset on the Free Application for Federal Student Aid (FAFSA). But withdrawals from the account are reported as untaxed income to the student, reducing aid eligibility by as much as 50% of the distribution amount. (Students are allowed up to \$6,600 in annual income before aid is reduced.) To get around that issue, grandparents can time their distributions. Distributions made after January 1 of the student's sophomore year won't show up on the FAFSA, assuming he or she graduates in four years.

Another option: Roll over a year's worth of funds at a time to a parent-owned 529 plan. If the rollover occurs after the FAFSA is filed and if the funds are spent before the next FAFSA is submitted, the money won't show up as an asset on the FAFSA, and distributions won't affect aid eligibility.

## Convert to a Roth

You can't roll over your RMD to another IRA. But after you take your distribution for the year, you can convert some or all of your traditional IRA to a Roth, which will reduce the balance that's subject to RMDs in the future. Although this is normally done before age 70½ (see below), converting after that age could still benefit you and your heirs.

You don't need to take RMDs from a **Roth IRA**, and you can tap the converted money tax- and penalty-free after you keep the money in the Roth for more than five years. Roth distributions don't count when calculating taxes on Social Security benefits and the Medicare premium surcharges for high-income taxpayers, as traditional IRA distributions do. Leaving a large Roth rather than a traditional IRA to your heirs is a plus for them as well because the income is tax-free (even though they will be subject to RMDs). If the **Secure Act** passes, Roth IRAs will become even more attractive, as one provision erases a non-spouse heir's ability to stretch out RMDs from inherited retirement accounts over his or her own life expectancy and instead mandates that the inherited assets be withdrawn within 10 years.

Use the excess cash flow from unneeded RMDs to pay the tax bill associated with Roth conversions, says Winter. You can also smooth out the tax bill by converting smaller amounts over a number of years.

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## The route to lower taxes

The decade before you turn 70½ is the "sweet spot" for RMD planning, says Maria Bruno, head of U.S. wealth planning research at Vanguard. If you expect that you won't need your RMD in full, or at all, after you turn 70½, you have time to take steps that will lower your required distributions.

Taking money out of your tax-advantaged retirement accounts after you retire but before you turn 70½ can be prudent, especially if you're in a lower tax bracket than you'll be in when your income includes RMDs, Social Security (assuming you delay benefits) and other sources. By lowering your account balance, you're reducing future RMDs, and the distributions may be taxed at a lower rate. "Investors are starting to plan more proactively, even if it does fly in the face of the 'defer, defer, defer' financial-planning tenet we preached for years," says Bruno.

**Consider a Roth conversion.** Your sixties are also a prime time to convert some or all of your traditional IRA to a Roth IRA, especially if your income dips right after you retire and you're in a lower tax bracket. Chris Pollard, a CFP and principal of Great

Path Planning in Goshen, N.Y., finds that with some clients, their tax brackets when Social Security and RMDs kick in could be similar to when they were working. Although you will have to pay taxes on the money you convert to a Roth, the money will grow tax-free in retirement and is not subject to RMDs. “My general rule is if you don’t plan to touch the money or don’t think anyone would receive the benefit for 15 years, do the conversion,” says Pollard.

Bob Hite, of Asheville, N.C., holds the bulk of his portfolio in a Roth IRA, which he converted from his 401(k) in 2010. “My timing on that was really sweet,” he says. “My Roth has more than doubled.” He and his wife consider the Roth their back-up in case of severe health issues.

For many people, the best strategy is to spread your Roth conversions over several years, rather than making large conversions that will ring up a bigger tax bill than the RMD itself. Engage in “tax bracket limbo” by converting enough money to fill up the highest bracket that is palatable to you now, especially if you predict your bracket will rise in future years, says Pollard. “Take advantage of the fact that the tax code is really flat for a good amount of income,” says Paul Winter, president of Five Seasons Financial Planning in Salt Lake City.

Money invested in a Roth 401(k) is subject to RMDs, although it will not be taxed. But you can avoid taking RMDs altogether by rolling your Roth 401(k) into a Roth IRA.

If you’re worried about running out of money over a long retirement or you want a steady stream of income later in life, when you may need it most, consider investing in a deferred-income annuity known as a qualified longevity annuity contract (QLAC). You can invest up to \$130,000 from your IRA in a QLAC (or up to 25% of the balance in all of your traditional IRAs, whichever is less) at any age. You’ll pick the age when you’d like to start receiving annual lifetime income (no later than age 85); the longer you wait, the more you’ll get. A joint life contract will reduce payouts, but it guarantees that income will continue for as long as you or your spouse is alive. You can also decide whether you want a death benefit, which will also reduce your payout but will ensure that your beneficiaries recoup what you invested in the QLAC, minus any payments.

In the best-case scenario, “you will pull a lot more income off the amount you originally invested,” says Keith Moeller, a wealth management adviser at Northwestern Mutual. By excluding as much as \$130,000 from your IRA, you’ll reduce the taxable income generated by your RMDs in the present, although you’ll still need to pay taxes on the income when you start receiving payments.

Instead of delaying your payout as long as possible—and risking dying before you see your money—consider laddering your investment to start payouts at different ages, says Jerry Golden, founder of Go2Income.com. To test different scenarios and get quotes from QLAC providers, go to [go2income.com](http://go2income.com).

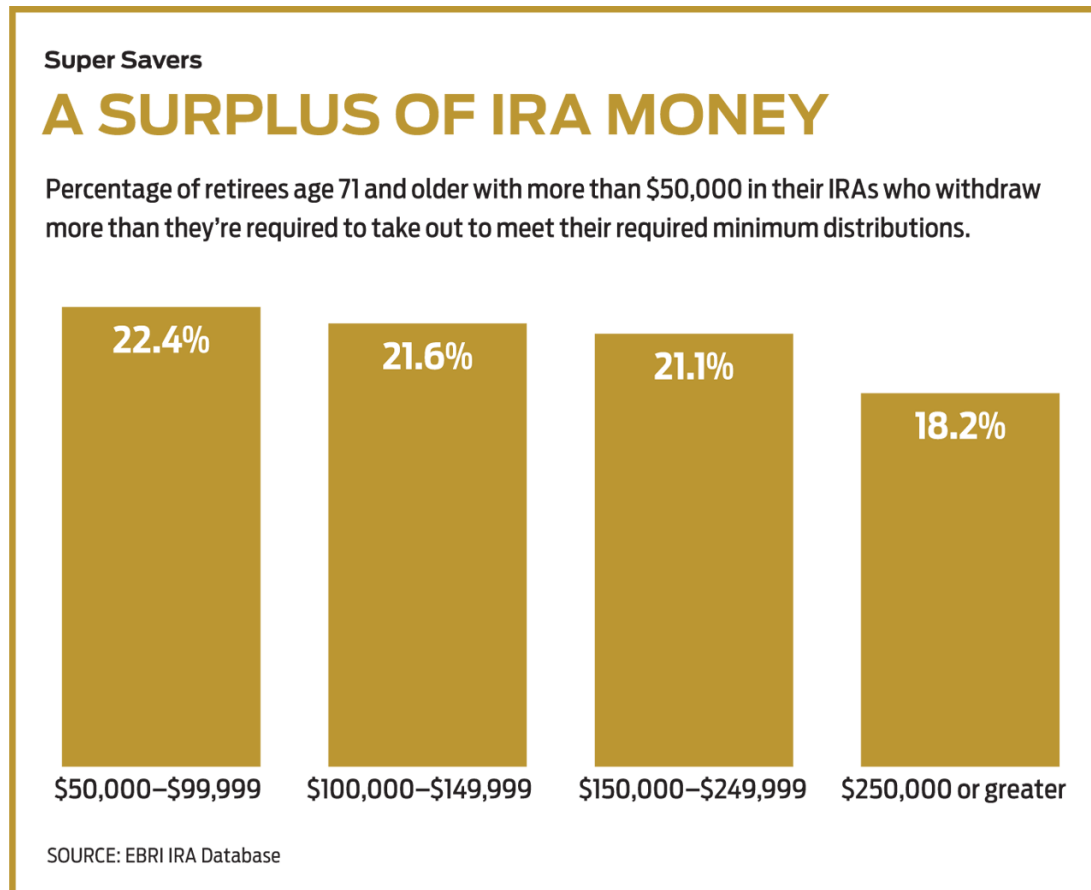
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Finally, if you plan to continue working past age 70½, you may be able to delay at least some RMDs. If you're still working at 70½, you can delay taking your RMD from your current employer's 401(k) (unless you own more than 5% of the company) until you retire. You will still be on the hook for RMDs from traditional IRAs and former employers' 401(k)s, but if your current employer allows it, you may be able to roll funds from other 401(k)s into your current plan and avoid taking RMDs on that money while you're still working. Some 401(k) plans even allow IRA rollovers, says Deva Panambur, a CFP and owner of Sarsi LLC in New York City.



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