Understanding IRA strategies for retirement

By Gretchen Miller, MBA, CFP,® Regional Planning Strategist

Often, high-net-worth clients have accumulated significant wealth on a tax-deferred basis in individual retirement accounts (IRAs) and employer-sponsored retirement plans. The tax deferral benefits of IRAs and employer-sponsored retirement plans were created to incentivize people to save for retirement. However, retirees eventually will have to pay the tax bill on these accounts. By educating yourself on these rules and strategies, you can help redefine your Golden Years – assisting in the management of retirement income and maintaining your and your family's lifestyle.

IRAs can be classified into two basic categories

Traditional IRA

Contributions to traditional IRAs can be fully deductible, partially deductible, or nondeductible. There are no income limits to contributing – everyone can contribute. However, the deductibility of your contribution will depend on your income level and whether you are an employer-sponsored plan participant.

Roth IRA

Contributions to Roth IRAs are nondeductible or after-tax. There are income limits on contributions, but not on conversions.

Roth IRAs must be held at least five years and at least until age 59½ to take tax-free and penalty-free withdrawals from earnings, but contributions can be withdrawn at any time.

IRA basics

In general, most qualified employer plans and IRAs are pretax money. If you have after-tax amounts in your traditional, SEP, or SIMPLE IRA, you must, when taking a distribution, determine how much of the distribution is attributable to the after-tax amount. This is calculated using IRS Form 8606. The portion of the distribution that is nontaxable must be prorated with amounts that are taxable. For instance, if the individual contributed $2,000 in after-tax amounts and has a pretax balance of $8,000, a distribution of $5,000 would be prorated to include $1,000 after-tax and $4,000 in pretax assets. This pro rata treatment must continue until all the after-tax amounts have been distributed.

To determine the portion of the distribution that is taxable, taxpayers must aggregate all of their traditional, SEP, and SIMPLE IRA's balances. This requirement applies even if the after-tax contribution was made to only one IRA.

Distributions to owners of IRAs prior to age 59½ are subject to a 10% early withdrawal penalty tax. However, distributions to IRA beneficiaries are not subject to the penalty tax regardless of the age of the beneficiary.

What to know about required minimum distributions

Required minimum distributions (RMDs) are amounts the federal government requires you to withdraw annually from certain retirement savings vehicles after you reach age 72. This includes traditional IRAs, SEP-IRAs, and SIMPLE IRAs. Employer-sponsored retirement plans that are subject to RMD rules include qualified defined contribution plans: 401(k) plans, Section 457(b) plans, and Section 403(b) plans. The Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019 changed the required beginning date to age 72.

Although these RMDs are required, some individuals may not need the funds. Required minimum distributions have the effect of producing taxable income when withdrawn—driving the retiree into a higher tax bracket when stacked on top of other sources of retirement income. The RMDs may cause a taxpayer to pay higher Medicare Part B premiums as well as affect Social Security taxation. Many strategies can be leveraged to minimize RMDs, both for those who have already reached the RMD phase and for those still accumulating towards it. The SECURE Act changed the required beginning date for IRAs and Employer-sponsored retirement plans effective January 1, 2020. Required minimum distributions for individuals who turned 70½ in 2019 or earlier are still subject to the old rules and must begin distributions at age 70½.

Tax diversification is important in retirement; therefore, positioning assets that are tax-free, tax-deferred, and taxable is a smart strategy. By ensuring you have different buckets of money and paying attention to the associated tax brackets, you will be better able to manage your tax liability.

RMD Basics

Owners of IRAs must begin distribution by April 1 of the year following the year the account owner reaches age 72. This is true whether the IRA owner is working or not.
Participants in employer-sponsored retirement plans, such as 401(k) plans, can wait until the later of 72 or when they stop working. ▶ **Exception:** Participants who own 5% or more of the business must take their first required distribution at age 72 regardless of whether they are still working or not.
Other than the first required distribution, which can be delayed to the April 1 deadline, all subsequent required distributions **must be made by December 31 of the year.**
The amount of the required distribution is determined by dividing the prior year-end account balance by the account owner's life expectancy using the IRS Uniform Life Table.
If the sole beneficiary of the IRA is a spouse who is more than 10 years younger, the Joint Life and Last Survivor Expectancy table is used to calculate RMDs. IRA owners will not be required to withdraw as much money each year as you would if your spouse were older.
RMDs will increase each year on a percentage basis.
▶ IRA owners or plan participants who fail to make the required distribution for a given year must correct the error and pay a 50% penalty tax.

RMD aggregation

RMDs must be taken from each employer-sponsored retirement plan. However, IRAs can be aggregated for RMD calculation purposes with the RMD only taken from one or less than all IRAs. This could permit the IRA owner to satisfy the RMDs from more liquid accounts and keep other IRAs fully invested for continued growth potential.

Strategies for managing RMDs and taxable income

Roth IRA conversions

If reducing RMDs is a top concern for you, you may want to consider a Roth conversion. This is because you are not required to take RMDs from your Roth IRA during your lifetime. While conversion is a taxable event, you can exchange a one-time tax hit for a lifetime of never having to worry about RMDs and their tax consequences. The conversion should be done while you are in a lower tax rate. In the future, with added Social Security distributions and other retirement income, your tax rate may be higher. With a Roth conversion, the funds stay in a tax-free account and benefit from this for the rest of the owner's and the surviving spouse's lifetime. Keep in mind your nonspouse beneficiaries will need to take distributions from the inherited Roth IRA. However, these distributions will most likely be tax-free.

Qualified charitable distribution

For clients who do not need the income from the required distribution, they could take advantage of the qualified charitable distribution. Clients over age 70½ can distribute up to $100,000 each year directly from an IRA to qualified charities. The distribution can be used to satisfy the taxpayer's RMD, and the distribution will not be added to the taxpayer's taxable income. The SECURE Act did not change the eligibility age to make qualified charitable distributions.

Recycle RMDs

Married couples can consider "recontributing" an RMD back into a younger spouse's IRA or employer retirement plan instead. The younger spouse must be eligible to contribute in the first place. The couple will receive a tax deduction that offsets the couple's RMD obligation.

Take excess distributions from accounts already subject to RMDs

If an RMD must come from some pretax retirement account, it is better to take the additional distribution from the same account that is already funding the RMDs. The idea is for a couple to keep as much of the younger spouse's retirement account dollars in place as possible so that it can compound as long as possible and take retirement spending dollars from the account that is required to be liquidated by RMDs anyway. The excess distribution will further reduce the retirement account value and therefore the amount of the RMD in future years.

Asset location

Upon turning 72, it can make sense for some investors to use tax-deferred accounts for bonds and bond funds, and use taxable accounts for stock and stock funds. The advantage is that bonds and bond funds, like retirement accounts, are taxed at ordinary income rates already, while stock and stock funds in a taxable account benefit from the reduced capital gains rate. Also, because bonds have historically underperformed stocks, it is likely that you will have fewer gains in bond-heavy retirement accounts. And because RMDS are based on the previous year-end value of your IRA account, an IRA account that grows more slowly will produce smaller RMDs.

Beneficiary distribution planning is just as important as distributions when the original IRA owner was alive. Please note not all beneficiary distribution options may be available in a qualified employer plan.

IRA death distribution options

The beneficiary distribution options available to beneficiaries of IRAs and employer sponsored retirement plans, including 401(k), 403(b), 457(b) plans, and the Thrift Savings Plan, have changed considerably with the passage of the Setting Every Community Up for Retirement Enhancement (SECURE) Act on December 20, 2019. These new rules went into effect on January 1, 2020. The effective date is extended for two years (for deaths after December 31, 2021) for governmental plans, including 403(b), 457(b) plans, and the Thrift Savings Plan. It is important that you review these rules with your financial advisor to make sure you are making the best decision when naming beneficiaries of retirement accounts.

To determine what beneficiary distributions options will be available upon the death of the IRA owner or plan participant we must first determine what type of beneficiary we are working with. Under the SECURE Act, there are now three kinds of beneficiaries for determining post-death payouts after 2019.

Non-Designated Beneficiary (NDB)

These are not people. Examples: Charity, Estate, or non-qualifying trust. No change from prior law.

If the account owner dies before the required beginning date (RBD) (age 72), the account must be withdrawn by the end of the fifth year after death.

If the account owner dies on or after the required beginning date, RMDs must be taken over the deceased IRA owner's (or plan participant's) remaining single life expectancy.

Required minimum distribution must be taken by the beneficiary in each of those years.

Non-Eligible Designated Beneficiary (NEDB)

These are all designated beneficiaries who do not qualify as Eligible Designated Beneficiaries (EDB). Examples: grandchildren, older children, some qualified trusts.

Entire account must be emptied by the end of the 10th year after death. (new 10-year rule)

Required minimum distributions do NOT need to be taken by the beneficiary.

Eligible Designated Beneficiary (EDB)

This is a new category of beneficiaries created under the SECURE Act.

Five classes of eligible designated beneficiaries:

- Surviving spouse
- Minor children, up to age of majority – but not grandchildren
- Disabled individuals – under the strict IRS definition
- Chronically ill individuals
- Individuals not more than 10 years younger than the IRA Owner

In addition, trusts for the sole benefit of these eligible designated beneficiaries should qualify as an EDB.

These eligible designated beneficiaries are able to stretch distributions over their single life expectancy. The beneficiary required distribution (stretch) is determined by dividing the IRA balance on December 31 of the year preceding the year of distribution by the beneficiary's life expectancy factor as determined through the IRS Single Life Table. Taking distributions over life allows the beneficiary to receive smaller distributions each year and stretch the tax liability over his or her lifetime

Once these beneficiaries no longer qualify as EDBs or die, the 10-year distribution rule is applied for them, or their successor beneficiaries. An example of this would be a child that originally was a minor that stretched distributions over their single life expectancy until they reached the age of majority (age 18 in many states) and then began distributions under the 10-year rule.

Timing is critical

The surviving spouse beneficiary must begin distributions by December 31 of the year in which his or her deceased spouse would have attained age 72. Prior to this point, the surviving spouse is not required to make distributions, although he or she may elect to do so at any time.

Spouse as beneficiary

A spouse who is the beneficiary to his or her deceased spouse's IRA or retirement plan has more options than does a non-spouse beneficiary. A surviving spouse can:

- Roll over the account to an IRA in the surviving spouse's name
- Treat the IRA as a beneficiary account (stretch the IRA)

Spousal assumption is the most common option elected by surviving spouses. If the surviving spouse is named as the beneficiary to the decedent's IRA, the surviving spouse may elect to treat the account as his or her own. In this case, the surviving spouse would take distributions from the account upon attaining age 72 under the normal RMD rules. Note that distributions would not be required before that date, nor are they prohibited. The surviving spouse may elect this option at any time, even if he or she has previously treated the account as a beneficiary IRA and has taken distributions.

Stretching vs. spousal assumption

Leaving the IRA as a beneficiary IRA provides certain advantages depending on the age of the surviving spouse. If the surviving spouse is under age 59½, he or she might choose to keep the account as a beneficiary to avoid the 10% premature penalty on distributions. Later, the account could be switched to his or her personal IRA. During the period the account is held as a beneficiary account, no distributions would be required until the year in which the decedent would have reached age 72. Once the surviving spouse elects to treat the account as their own, distributions would be required once the surviving spouse reaches age 72. The surviving spouse's ability to assume ownership can be exercised at any time. By correctly timing the use of beneficiary status and the assumption of ownership, the beneficiary spouse could avoid the 10% penalty for an extended period.

If the surviving spouse is over age 72 and the decedent spouse was not, the surviving spouse could avoid RMDs by leaving the account in beneficiary status as distributions from the beneficiary account are not required until the decedent would have been 72.

Trusts as beneficiary

The SECURE Act eliminated the lifetime RMD stretch for the majority of trusts named as IRA or plan beneficiaries. In many cases the 10-year payout will now apply. Since many trusts were created for post-death control of distributions, it is essential that existing trusts be reviewed to ensure all trust beneficiaries receive the most favorable distribution options. Many trusts will have to be revised or completely redone to accommodate the new provisions of the SECURE Act.

Getting on the right path

The right IRA strategy can set a course for your retirement. It is paramount to understand your options, the array of accounts you have available, and the right mix to make your golden years the brightest they can be.

To start planning or to reimagine your retirement, contact your Key Family Wealth Advisor.

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