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GETTING THE MOST OUT OF YOUR IRA AND 401(k)

Tax-deferred retirement savings vehicles such as IRAs and 401(k)s provide great opportunities for sheltering funds and their growth from income taxes for an extended period of time. But income tax cannot be deferred forever. Sooner or later, someone is going to have to pay income taxes on what you have accumulated in your tax-deferred retirement savings account. Important decisions you make—or do not make—will determine how the money will be paid out of the account, who will pay the income taxes on the payouts, and how much income tax will ultimately have to be paid.

Payout Basics

Payouts from IRAs and 401(k)s are age-driven. In general, you cannot withdraw from your tax-deferred retirement savings before you reach age 59½ without paying a penalty. When you turn 59½, you may begin to take withdrawals without penalty, but withdrawals are not required. Withdrawals are required once you reach your required beginning date (RBD), which is the April 1 after you turn 70½. Beginning in the year in which this RBD falls, you must take required minimum distributions (RMDs) each year or else penalties are imposed. Regardless of when you withdraw the funds or whether withdrawal triggers a penalty, you will be required to pay income tax on any amount withdrawn from your retirement savings.

Calculation of the RMDs

The minimum amount that must be withdrawn from your retirement savings each year to avoid penalty is dictated by two important decisions that must be made before your RBD. The two critical choices you must make are: (1) who the beneficiaries of your account will be, and (2) how the life expectancy for the account will be calculated. These two choices—irrevocable after your RBD passes—play a critical role in how future minimum payouts are calculated, both during your life and after your death. If you make the wrong choices, or if you ignore these choices and let the default rules come into play, you can lose an astounding percentage of your accrued savings to income taxes.

Your choices regarding account beneficiaries and calculation of life expectancy work together to determine how fast the money has to be withdrawn from your retirement savings account. This is important because the duration of the payout period dictates how much income tax will be owed on the distributions. With tax-deferred plans, the general rule is that the longer the payout period, the better. With a shorter payout period, money must be withdrawn in higher amounts each year, thereby generating a higher income tax liability.

Designated Beneficiaries

Whether your named beneficiary qualifies as a "designated beneficiary" affects the length of the payout period for which your account will be eligible. If you do not name a designated beneficiary for your account, the payout period will be limited to your own life expectancy. If you do name a designated beneficiary, the payout period can be stretched out over the joint life expectancy of you and your designated beneficiary. In order to be a "designated beneficiary," your beneficiary must be an individual (such as your spouse), a group of individuals (such as your children), or an irrevocable trust with a properly drafted trust agreement. If you leave your retirement account to your estate, the trustee of an improperly drawn trust, or a charity, you will not have a proper designated beneficiary, and you will be stuck with the shorter payout period as measured by your life expectancy alone.

Should you die without a designated beneficiary before you reach age 70½, the total amount in your account must be distributed, and income taxes paid on it, within five years of your death. Should you die without a designated beneficiary after you reach 70½, the account must be paid out over only your own remaining life expectancy.

Remember that although most retirement plans allow you to name or change a beneficiary at any time, the designation in place on your RBD is the designation that will be used to calculate the payout period for your account. After your RBD, any change to your beneficiary designations cannot slow down or stretch out the payout period.

Calculation of Life Expectancy

The law intends for your RMDs to deplete your retirement savings account over the course of your life expectancy (or over the joint life expectancy of you and your designated beneficiary). How you choose to calculate your life expectancy determines how fast your account must be depleted. At your RBD you must choose between two methods for calculating your life expectancy: "fixed-term" or "recalculation." If you don't choose, the law will make a choice for you.

If you choose a "fixed-term" life expectancy, the mandated payout period for your retirement account will be a fixed number of years based on your life expectancy (or the joint life expectancy of you and your designated beneficiary) as it is calculated at the time you are age 70½. Your account must be paid out over this fixed number of years. If you choose fixed term calculation of your own life expectancy and have no designated beneficiary, whoever is entitled to the remainder of your account after your death will receive distributions over the rest of your life expectancy. If you have a properly designated beneficiary and can use a joint life expectancy to calculate the payout period, your beneficiaries will continue to get payments after your death, stretched over the longer term of your joint life expectancies.

The drawback to selecting a fixed-term life expectancy for calculating the payout period is that if you live longer than the calculated expectancy, you will outlive your retirement account. The "recalculation" method of determining life expectancy attempts to resolve this problem. Under this method, your projected life expectancy is recalculated each year as you age, which in turn adjusts the amount that must be paid out of your account each year to deplete the account over the duration of your life expectancy. But this method is not without its disadvantages.

Under the recalculation method, when the account owner dies, his or her life expectancy the next year is zero years. This means that, unless the account owner has a designated beneficiary on which to base a joint life expectancy, the entire amount left in the account must be distributed by December 31 of the year of death. A large lump sum payout may result in a large income tax bill for heirs.

It Takes Planning

Knowing how to get the most out of your retirement savings accounts takes careful planning. The beneficiary designations and life expectancy calculations that are best for you will depend on your particular family and financial circumstances. For example, special rules apply when the designated beneficiary is the spouse of the account owner, and married couples need to plan together to choose their life expectancy calculation methods. If you have a larger estate, you will need to consider estate tax planning and how it coordinates with your income tax planning. To get the most out of your IRA or 401(k), you should seek the advice of both your financial advisors and your estate planning attorney.

4/1/18

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