

## Distributions from Traditional IRAs--After Age 70½

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### Introduction

A withdrawal from an IRA is generally referred to as a distribution. Ideally, you would have complete control over the timing of distributions from your traditional IRAs. Then you could leave your funds in your traditional IRAs for as long as you wished, and withdraw the funds only if you really needed them. This would enable you to maximize the funds' tax-deferred growth in the IRA, and minimize your annual income tax liability. Unfortunately, it doesn't work this way. You must take what are known as required minimum distributions from your traditional IRAs.

### What are required minimum distributions (RMDs)?

Required minimum distributions (RMDs), sometimes referred to as minimum required distributions (MRDs), are withdrawals that the federal government requires you to take annually from your traditional IRAs after you reach age 70½. You can always withdraw more than the required minimum from your IRA in any year if you wish, but if you withdraw less than required, you will be subject to a federal penalty tax. These RMDs are calculated to dispose of your entire interest in the IRA over a specified period of time. The purpose of this federal rule is to ensure that people use their IRAs to fund their retirement, and not simply as a vehicle of wealth transfer and accumulation.

**Tip:** In addition to traditional IRAs, most employer-sponsored retirement plans are subject to the RMD rule. Roth IRAs, however, are not subject to this rule. You are not required to take any distributions from a Roth IRA during your lifetime.

### When must RMDs be taken?

Your first RMD represents your distribution for the year in which you reach age 70½. However, you have some flexibility in terms of when you actually have to take this first-year distribution. You can take it during the year you reach age 70½, or you can delay it until April 1 of the following year. Since your first distribution generally must be taken no later than April 1 following the year you reach age 70½, this date is known as your required beginning date (RBD). Required distributions for subsequent years must be taken no later than December 31 of each calendar year until you die or your balance is reduced to zero. This means that if you opt to delay your first distribution until the following year, you will be required to take two distributions during that year--your first-year required distribution and your second-year required distribution.

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**Example(s):** You own a traditional IRA. Your 70th birthday is December 2 of year one, so you will reach age 70½ in year two. You can take your first RMD during year two, or you can delay it until April 1 of year three. If you choose to delay your first distribution until year three, you will have to take two required distributions during year three—one for year two and one for year three. That is because your required distribution for year three cannot be delayed until the following year.

## Should you delay your first RMD?

Your first decision is when to take your first RMD. Remember, you have the option of delaying your first distribution until April 1 following the calendar year in which you reach age 70½. You might delay taking your first distribution if you expect to be in a lower income tax bracket in the following year, perhaps because you're no longer working or will have less income from other sources. However, if you wait until the following year to take your first distribution, your second distribution must be made on or by December 31 of that same year.

Receiving your first and second RMDs in the same year may not be in your best interest. Since this "double" distribution will increase your taxable income for the year, it will probably cause you to pay more in federal and state income taxes. It could even push you into a higher federal income tax bracket for the year. In addition, the increased income may cause you to lose the benefit of certain tax exemptions and deductions that might otherwise be available to you. So the decision of whether or not to delay your first required distribution can be crucial, and should be based on your personal tax situation.

**Example(s):** You are single and reached age 70½ in 2004. You had taxable income of \$18,000 in 2004, and expect to have \$18,000 in taxable income in 2005. You have money in a traditional IRA and determined that your RMD from the IRA for 2004 was \$6,000, and that your RMD for 2005 is \$6,000 as well. You took your first RMD in 2004. The \$6,000 was included in your income for 2004, which increased your taxable income to \$24,000. At a marginal tax rate of 15 percent, federal income tax was approximately \$3,243 for 2004 (assuming no other variables). In 2005, you take your second RMD. The \$6,000 will be included in your income for 2005, increasing your taxable income to \$24,000 and resulting in federal income tax of approximately \$3,243. Total federal income tax for 2004 and 2005 will be \$6,486.

Now suppose you did not take your first RMD in 2004 but waited until 2005. In 2004, your taxable income was \$18,000. At a marginal tax rate of 15 percent, your federal income tax was approximately \$2,343 for 2004. In 2005, you take both your first RMD (\$6,000) and your second RMD (\$6,000). These two \$6,000 distributions will increase your taxable income in 2005 to \$30,000, taxable at a marginal rate of 25 percent. With a marginal rate of 25 percent, federal income tax will be approximately \$4,238. Total federal income tax for 2004 and 2005 will be roughly \$6,581—almost \$100 more than if you had taken your first RMD in 2004.

## How are RMDs calculated?

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RMDs are calculated by dividing your traditional IRA account balance by the applicable distribution period. Your account balance is calculated as of December 31 of the year preceding the calendar year for which the distribution is required to be made.

**Caution:** When calculating the RMD amount for your second distribution year, you base the calculation on the total interest in the IRA or plan as of December 31 of the first distribution year (the year you reached age 70½), regardless of whether or not you waited until April 1 of the following year to take your first required distribution.

**Example(s):** You have a traditional IRA. Your 70th birthday is November 1 of year one, and you therefore reach age 70½ in year two. Because you turn 70½ in year two, you must take an RMD for year two from your IRA. This distribution (your first RMD) must be taken no later than April 1 of year three. In calculating this RMD, you must use the total value of your IRA as of December 31 of year one.

## What if you fail to take RMDs as required?

If you fail to take at least your RMD amount for any year (or if you take it too late), you will be subject to a federal penalty tax. The penalty tax is a 50 percent excise tax on the amount by which the RMD exceeds distributions actually made to you during the taxable year. You report and pay the 50 percent tax on your federal income tax return for the calendar year in which the distribution shortfall occurs.

**Example(s):** You own one traditional IRA and compute your RMD for year one to be \$7,000. You take only \$2,000 as a year-one distribution from the IRA by the date required. Since you are required to take at least \$7,000 as a distribution but have taken only \$2,000, your RMD exceeds the amount of your actual distribution by \$5,000 (\$7,000 minus \$2,000). You are therefore subject to an excise tax of \$2,500 (50 percent of \$5,000), reportable and payable on your year-one tax return.

## Tax considerations

### *Income tax*

Like all distributions from traditional IRAs, distributions taken after age 70½ are generally subject to federal (and possibly state) income tax for the year in which you receive the distribution. However, a portion of the funds distributed to you may not be subject to tax if you have ever made nondeductible (after-tax) contributions or if you've ever rolled over after tax dollars from an employer-sponsored retirement plan to your traditional IRA. Since nondeductible contribution amounts were taxed once already, they will be tax free when you withdraw them from the IRA. You should consult a tax professional if your traditional IRA contains any nondeductible contributions.

**Caution:** Taxable income from an IRA is taxed at ordinary income tax rates even if the funds represent long-term capital gains or qualified dividends from stock held within the IRA.

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When you take a distribution from your traditional IRA, there is no requirement that your IRA trustee or custodian withhold federal income tax on the distribution. However, the trustee or custodian generally will withhold tax at a rate of 10 percent unless you provide the trustee or custodian with written instructions that you do not want any tax withheld on the distribution. Even if tax is withheld at 10 percent, that may not be sufficient to cover your full tax liability on the distribution.

**Tip:** If you receive an annuity or similar periodic payment, tax withholding is generally based on your marital status and the number of withholding allowances you claim on your withholding certificate (Form W-4P). No withholding or waiver is needed when the distribution is a trustee-to-trustee transfer from one IRA to another (see below).

## **Estate tax**

You first need to determine whether or not federal estate tax will apply to you. If you do not expect the value of your taxable estate to exceed the federal applicable exclusion amount (\$1.5 million for 2004 and 2005), then federal estate tax may not be a concern for you. Otherwise, you may want to consider appropriate strategies to minimize your future estate tax liability.

For example, you might reduce the value of your taxable estate by gifting all or part of your RMD to your spouse or others. Making gifts to your spouse may work well if your taxable estate is larger than your spouse's, and one or both of you will leave an estate larger than the applicable exclusion amount. This strategy can provide your spouse with additional assets to better utilize his or her applicable exclusion amount, thereby minimizing the combined estate tax liability of you and your spouse. Be sure to consult an estate planning attorney, however, about this and other strategies.

**Caution:** In addition to federal estate tax, your state may impose its own estate or death tax. Consult an estate planning attorney for details.

## **IRA rollovers**

In general, a rollover is the movement of funds from one retirement savings vehicle to another—in this case, from one traditional IRA to another. A rollover generally must be completed within 60 days of the date the funds are released from the distributing account. Rollovers are treated separately from contributions; you are still allowed to make your regular IRA contribution in a year when you have a rollover transaction. There are no age limits for rollovers, but you must remember to take your RMD each year after you reach age 70½ (you cannot roll over an RMD itself). If properly completed, rollovers are not subject to income tax or the premature distribution tax. There are two possible ways that IRA funds can be rolled over.

**Tip:** You can roll over funds from a traditional IRA to another traditional IRA or you can roll over funds from a Roth IRA to another Roth IRA. Special rules apply to converting or rolling over funds from a traditional IRA to a Roth IRA. See Converting or rolling over traditional IRAs to Roth IRAs, below. You may also be able to roll over funds from an IRA to an employer-sponsored retirement plan.

## ***You receive the funds and reinvest them***

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With this method, you actually receive a distribution from your traditional IRA. To complete the rollover transaction, you make a deposit into the IRA that you want to receive the funds. You are allowed to do this only once in a 12-month period. If you receive a second distribution from the same IRA within a 12-month period, you cannot roll it over (you also can't make a rollover from the IRA you roll the funds into for 12 months). Also, you must deposit the full amount distributed to you within the allowable 60-day period. If you fail to complete the rollover or miss the 60-day deadline, your distribution will be treated as taxable.

**Example(s):** On January 2, you withdraw your IRA funds from a maturing bank CD. The bank cuts a check payable to you for the full balance of the account (assuming you opt for no income tax withholding). You plan to move the funds into an IRA account at a competing bank. Fifteen days later, you go to the new bank and deposit the full amount of your IRA distribution into your new rollover IRA. Your rollover is complete.

Now assume the same scenario as above, except that when you receive your check from the first bank, you cash the check and lend the money to your brother, who promises to repay you in 30 days. As it turns out, he doesn't repay the loan until March 5 (the 62nd day after your distribution). You deposit the full sum into the IRA account at the new bank. However, because you didn't complete your rollover within 60 days, the January 2 distribution will be taxable (excluding any nondeductible contributions, as described above).

If federal income tax is withheld from a distribution and you wish to roll over the distribution, you have to make up the amount withheld for taxes out of your own pocket. Otherwise, the rollover is not considered complete, and the shortfall is treated as a taxable distribution.

**Example(s):** You take a \$1,000 distribution (all of which would be taxable) from your traditional IRA that you want to roll over into a new IRA. One hundred dollars is withheld for federal income tax, so you actually receive only \$900. If you roll over only the \$900, you are treated as having received a \$100 taxable distribution. To roll over the entire \$1,000, you will have to deposit in the new IRA the \$900 that you actually received, plus an additional \$100. (The \$100 withheld will be claimed as part of your credit for federal income tax withheld on your federal income tax return.)

**Tip:** The IRS is able to extend the 60-day period, in limited circumstances, when the failure to timely complete the rollover is not the taxpayer's fault.

### ***Trustee-to-trustee transfer***

The second type of rollover transaction occurs directly between the trustee or custodian of your old traditional IRA, and the trustee or custodian of your new traditional IRA. You never actually receive the funds or have control of them, so a trustee-to-trustee transfer is not treated as a distribution (and therefore, the issue of tax withholding does not apply). Trustee-to-trustee transfers avoid the danger of missing the 60-day deadline and are not subject to the "once per 12 month" limitation.

**Example(s):** You have a traditional IRA invested in a bank CD with a maturity date of

January 2. In December, you provide your bank with instructions to close your CD on the maturity date and transfer the funds to another bank that is paying a higher CD rate. On January 2, your bank issues a check payable to the new bank (as trustee for your IRA) and sends it to the new bank. The new bank deposits the IRA check into your new CD account, and your trustee-to-trustee transfer is complete.

This is generally the safest, most efficient way to move IRA funds. Taking a distribution yourself and rolling it over only makes sense if you need to use the funds temporarily, and are certain you can roll over the full amount within 60 days.

## Converting or rolling over traditional IRAs to Roth IRAs

Have you done a comparison and decided that a Roth IRA is a better savings tool for you than a traditional IRA? If so, you may be able to convert or roll over an existing traditional IRA to a Roth IRA. However, be aware that you will have to pay income tax on all or part of the traditional IRA funds that you move to a Roth IRA. It is important to weigh these tax consequences against the perceived advantages of the Roth IRA. This is a complicated decision, so be sure to seek professional assistance. For more information, see [Roth IRA and Converting or Rolling Over Traditional IRAs to Roth IRAs](#) .

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