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Required Minimum Distribution Rules Refresher

Most retirement plans require savers to begin taking annual distributions when they reach age 70½, including 401(k) plans, 403(b) plans, governmental 457(b) plans, SEP IRA plans, SIMPLE IRA plans, and traditional IRAs.[1] These plans hold primarily pre-tax contributions with tax-deferred investment earnings, so the required minimum distribution (RMD) rules ensure these tax-sheltered savings ultimately become taxable. There are subtle differences in the RMD rules for defined contribution plans, like 401(k) plans, as compared to IRAs. Understanding these differences presents an opportunity for plan advisors to help their clients not only comply with the RMD rules to avoid penalties, but also to build retirement income strategies that take the tax impact of RMDs into consideration.

401(k) RMDs

Timing – Plan participants must generally begin taking RMDs at age 70½.[2] The plan participant has until April 1 of the year following the year they reach age 70½ to take the first year's RMD. This April 1 date is referred to as the Required Beginning Date (RBD).[2] Some 401(k) plans allow participants who are still employed beyond age 70½ to delay starting their RMDs until the participant actually separates from service. This option is not available to a plan participant who owns more than 5% of the employer.[2] After the first year's RMD, each subsequent year's RMD must be distributed by December 31.[3] Delaying a first-year RMD into the following year will result in two taxable distributions in the same calendar year, a factor to be considered in retirement income planning.

Calculation – The amount to be distributed each year is calculated by dividing the prior-year December 31 account balance by an applicable distribution period or life expectancy factor.[3] In most cases, the participant will use the life expectancy factor from the IRS's Uniform Lifetime Table (based on the participant's age and a hypothetical beneficiary 10 years younger). If the sole beneficiary of the account is a spouse who is more than 10 years younger than the plan participant, the joint life expectancy will be based on the actual ages of the participant and the spouse. This results in a smaller RMD amount. If you want to help your clients estimate their RMDs for retirement income planning purposes, you can find the tables used for these calculations in IRS Publication 590-B, *Distributions from Individual Retirement Arrangements (IRAs)* at www.irs.gov.

Taxation – 401(k) plan RMDs are fully taxable in the year distributed unless the participant made any after-tax contributions or Roth contributions to the plan. Designated Roth accounts are subject to the RMD rules, even though the distributions may not be taxable.

Potential Penalty – The plan administrator, typically the employer in a small or mid-sized plan, is legally responsible for calculating RMDs and ensuring the distributions are completed each year, though most plan sponsors will rely on their recordkeeper to help them administer RMDs. If a participant does not provide payment instructions, the employer will initiate the RMD payment because failure to distribute RMDs can jeopardize the qualified status of the plan.[1] If an RMD is missed, the plan participant is also on the hook for a 50% excess accumulation excise tax on the portion of the RMD amount that should have been distributed but was not.[4]

New for 2018 – The IRS has directed its plan examiners not to challenge a plan for failing to meet the RMD requirements if the plan cannot locate a participant to receive an RMD.[5] To secure this relief, employers must take the following steps to locate missing participants:

- Search plan and related records, as well as publicly available records or directories for alternative contact information.
- Use a commercial locator service, a credit reporting agency, or a proprietary Internet search tool for locating individuals.
- Attempt contact using certified mail to the last-known mailing address, and through appropriate means for any address or contact information (including email addresses and telephone numbers).

IRA RMDs

IRA RMDs generally follow the same rules as 401(k) RMDs, but there are some important differences that individuals should consider as they build their retirement income strategies and evaluate whether to leave retirement assets in their former employer's plan or roll it to an IRA.

1. Unlike a 401(k) plan in which the plan sponsor manages RMDs, the IRA owner is responsible for calculating each year's RMD and making sure the correct amount is distributed. Although the IRA trustee or custodian is required to alert an IRA owner by January 31 if an RMD is due for the year, the trustee or custodian will typically wait for the IRA owner's payment instructions before paying out an RMD. If an IRA owner fails to withdraw the RMD, they will owe the 50% excess accumulation excise tax on the amount that wasn't distributed.
2. If an individual owns more than one IRA (including traditional, SEP or SIMPLE IRAs), they may aggregate the RMD amounts for each IRA and distribute the total amount from just one IRA or split the total amount among their IRAs in any way they choose.[6] This allows IRA owners to choose which investments to liquidate across their various IRAs.
3. Roth IRAs are not subject to the RMA rules while the IRA owner is alive.[7] This allows retirement savings to grow without being depleted each year, yet the assets remain accessible if needed. As long as the IRA owner has had a Roth IRA for at least five years, any distributions they take (and all distributions to beneficiaries after their death) will be tax-free. An RMD for a traditional (pre-tax) IRA may not be satisfied by a Roth IRA distribution.

Advisor Action Steps

- **Help plan sponsors understand their RMD responsibilities** – Educate plan sponsors about the importance of distributing RMDs on time, and confirm they understand the RMD support services provided by their recordkeeper.
- **Educate participants about RMD timing and taxation rules** – Include a review of the RMD rules in your participant education curriculum, including the ability to diversify taxation if Roth contributions are a plan option.

Footnotes

[1] *Treas. Reg.1.401(a)(9)-1*

[2] *Treas. Reg.1.401(a)(9)-2*

[3] *Treas.Reg.1.401(a)(9)-5*

[4] *IRC Sec. 4947*

[5] *IRS, Memorandum for Employee Plans (EP) Examinations, Missing Participants and Beneficiaries and Requirement Minimum Distributions, October 19, 2017.*

[6] *Treas. Reg.1.408-8*

[7] *IRC Sec/ 408A*