Don’t Fear The Reaper (RMDs)

I’ve now run into a misunderstanding enough times that I think it’s worth writing a post about it. I call this misunderstanding “Inappropriate Fear of Required Minimum Distributions (RMDs).” It is when the fear that your RMDs will be large and cause you a large tax burden in retirement causes you to make a bad financial move. In this post, I’ll discuss RMDs, what an appropriate response is if you truly will have an “RMD Problem,” and why the inappropriate responses are wrong.

What Is A Required Minimum Distribution?

Starting at 70 1/2, you have to start taking money out of your tax-deferred accounts like 401(k)s and IRAs. Technically, RMDs also apply to inherited IRAs prior to age 70 1/2. They also apply to Roth 401(k)s, but since they do not apply to Roth IRAs, the easy solution there is to roll the Roth 401(k) over to a Roth IRA. Voila- no more RMDs. At age 70, the RMD is about 3.6% of the nest egg. That’s amazingly similar to what you actually WANT to pull out of your retirement accounts and spend based on a 4% withdrawal rate unless you plan to be the richest person in the graveyard. As time goes on, those RMDs go up as a percentage of your account. By the time you're 90, the percentage is 8.8% of the current nest egg. However, that is quite likely very similar to 4% of the original nest egg adjusted for inflation. In fact, just taking out your RMD and spending it is a completely reasonable way to spend down your nest egg in a safe way.

Bear in mind, of course, that an RMD need not be spent. You can simply pull the money out of your IRA, pay the tax on it, and invest the rest in a taxable account. Nobody is making you spend it. Also, bear in mind, if you are a high-income professional, that you likely saved 32-37% when you put that money in and you are likely pulling it out at rates of 0-24%. Saving at 37% and paying at an effective rate of 15% is a winning combination, even if the tax bill is larger on an absolute basis due to a few decades of compounding.

First World Problem

Now, let's describe the RMD "problem." A true RMD problem is someone who will actually pay taxes at a higher rate upon withdrawal than they paid during their peak earning years. If ever there were a first world problem, this would be it. If your RMD at age 70 is 3.6% of your nest egg, and your peak earnings years marginal federal tax rate is 37% (like mine is), how large would your tax-deferred account have to be in order for you to pay 37% on ANY of your RMD? Let's give you the benefit of the doubt and say you have $100K of other taxable income from your taxable account and Social Security. The top tax bracket starts at a taxable income of $600,000 (married). Let's say a gross income of $700K to make things easy and $100K worth of deductions. Subtract out another $100K worth of taxable account and Social Security income, leaving $500K coming as an RMD. $500K/3.6% = $13.9 Million. In today's dollars. That's right. You may need an IRA of nearly $14M in order to have this first world problem. (Remember that's in today's dollars since the brackets are adjusted for inflation.) And that's just for the marginal tax rate to EQUAL your current marginal tax rate. The effective tax rate in the future would still be less than your current marginal tax rate as that entire $500K wouldn't be taxed at 37%.

Just another first world problem.

My point is that this is a problem that only super savers are going to have. You're not going to have it with a $1M IRA and a $36K RMD. I mean, how much do you have to save a year at 5% real over 40 years to get $14M? About $110K. A year. For 40 years. And not spend any of it. Most of us don't even have access to $110K in tax-deferred contributions.

This is all a first world problem, of course. Assuming no change in the tax code, the only way you're going to be paying taxes at a higher rate than you paid during your peak earnings years is if you have more taxable income in retirement than you had during your peak earnings years. May we all be cursed with this problem. When you combine it with the usually dramatically lower expenses of retirement, it's going to be a heck of a party. Even with significant tax rate increases, if you do the math most are STILL going to be better off deferring taxes during their peak earnings years.

What To Do With an RMD Problem

Now, for the benefit of those rare people who will have a true RMD problem (who admittedly are concentrated in places like this website), let me describe the solution. The solution is to do Roth conversions. A Roth conversion is basically taking tax-deferred money and taxable money and moving them together into a tax-free account. So you might take $50K of tax-deferred money and convert it to a Roth and pay $20K in taxes. In essence, you're taking $50K of tax-deferred money (actually $30K in post-tax money) and $20K of taxable money and putting it into a Roth IRA. Now there are no more RMDs. If you recognize this is a problem you'll have, you can even do Roth 401(k) contributions as you go along and then move that money into a Roth IRA before age 70 1/2.

This solution allows your money to continue to grow in a tax-protected manner, eliminates RMDs, provides even more asset protection than you had previously (because some of the money was in taxable), facilitates estate planning through the use of beneficiaries, and allows the use of a Stretch Roth IRA.

This solution also works in a similar way for those who are able to do Roth conversions at a relatively low rate in their 50s and 60s after early retirement, even if they don't have a true RMD problem.
Another possible solution for those who are charitably

inclined is to give tax-deferred money to charities in lieu of cash (Qualified Charitable Distributions), a solution I wrote about last week. While you don't get the usual tax deduction too, you don't have to pay taxes on the charitable contribution and don't have to take an RMD, so that's really the same thing.

What NOT To Do With an RMD Problem

So now that we've pointed out what reasonable solutions are, let's point out what the solution IS NOT.

1 Pull all your money out now.

The solution is NOT to pull all the money out of your 401(k) now, pay the taxes and penalties, and reinvest it in taxable. This solution is generally advocated by someone who wants to sell you something, like whole life insurance. It's stupid. Not only do you pay the penalties, pay taxes at the highest possible rate, lose the asset protection benefits and lose the estate planning benefits, but you also lose the benefit of that tax-protected compounding for the rest of your life and that of your heirs. And you probably end up with a crummy investment. It's idiotic. Really, really dumb. Don't do that.

2 Avoid making tax-deferred contributions.

The second bad solution, although not as bad as the first, is the one I hear about more often by people who are trying to do the right thing. This is to quit contributing to a tax-deferred account in the first place and invest in taxable instead. The only reason to EVER pass up a tax-deferred account during your peak earnings years is if you have some investment opportunity that promises much higher returns than something you could buy in the tax-deferred account and you don't have the money to do both. Minimizing RMDs is NOT a good reason to avoid maxing out that account.

The reason why is that you can simply do a Roth conversion. You might not be able to do a Roth conversion of that money right then due to 401(k) rules. But you can probably do it later. Or you could do what is essentially the same thing in the same tax year by converting a DIFFERENT tax-deferred account. Money is fungible, you see.

> *Contribute $50K in the 401(k) + Convert $50K in the IRA to a Roth IRA = Contribute $50K to the Roth IRA*

Why would anyone choose to invest in taxable when they could invest in a Roth account? It makes no sense whatsoever. But that is what you are doing when you choose to invest in taxable instead of a tax-deferred account due to inappropriate fear of RMDs.

What do you think? Agree? Disagree? Why do you think people do dumb things to avoid RMDs? Comment below!