Advanced Planning: Planning for RMDs

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Speaker 1: Hello and welcome. My name is Carlos Zarate, and I'm joined today by Jim Barbee and we're with the Advanced Planning team here at AuguStar Financial. Jim, how you doing today?

Speaker 2: Good. How are you, Carlos?

Speaker 1: Hey, doing good. Thanks for asking. Jim, today I wanted to discuss required minimum distributions, also known as RMDs.

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Speaker 1: Will you give us a quick overview on what RMDs are?

Speaker 2: Sure. So, Carlos, taxpayers can defer state and federal income taxes on money that they contribute to certain qualified retirement accounts, like traditional individual retirement accounts, IRAs, or employer sponsored plans, like 401(k)s. Of course, it's the IRS and so they are going to want to tax that money eventually. And what they've done is come up with a scheme that requires taxpayers to start taking money out of these accounts when they reach a certain age. And the IRS has come up with calculations as to how much needs to be taken out every year and this is the required minimum distribution amount, which is then taxable.

Speaker 1: Got it then, Jim. Thanks. Now one confusing thing about RMDs is the deadline to take the first RMD. Once you turn RMD age, you have to take your first RMD. Can you give us some insight there?

Speaker 2: Yah, so the current minimum, required minimum distribution age is seventy-three unless you were born after 1959. If you were born after 1959, you don't have to start taking them until you turn seventy-five. Now, employer sponsored plans are a little bit different. Even if you fall into one of these age groups, you can delay taking the RMD as long as you're still working for the employer, and you own less than five percent of the company. Now, once you're required to start taking the RMD, your deadline to take the first one is April 1st of the following year. And then you have to take your second RMD by December 31st of that year as well. So, let's say I turn seventy-three this year, I can wait until April 1st of next year to take my first RMD. But I have to take my second RMD by December 31st of next year, as well. And then, every year after that RMDs are due on the 31st of each year. I should point out, Carlos, right now we're talking about just the original account owners. We'll talk about inherited accounts later. For now, there are substantial penalties on the original account owner for missed RMDs. The IRS has waived penalties on inherited accounts for the last four years for missing RMDs. But there's no indication they're going to do so again for 2025. So, it's really important for our listeners to be talking to their clients about timely taking RMDs and taking the correct amount.

Speaker 1: And, Jim, you had alluded to this earlier. The calculating RMDs, how does the IRS actually calculate what our required minimum distributions are?

Speaker 2: Yah, so, we take all of our IRAs and lump them together and come up with an amount. We take all of our 401(k)s and lump them together and come up with an amount. And then we use the IRS's, I'm using the uniform distribution table, which is used except when your beneficiary spouse is more than ten years younger than you. And we find your age and the divisor, and we divide the account value by that divisor. So, let's say at the end of last year, that's when we use it, then end of the prior year, all of my IRAs together aggregated to one hundred and ten thousand. And let's say I'm seventy-eight, I look at the chart, my divisor is twenty-two if I'm seventy-eight. So, I would divide my one hundred and ten thousand by twenty-two and my RMD amount would be five thousand. Now, I said I had multiple IRAs. I can take that five thousand from any or all of the IRAs. And then of course we do this same calculation with all of our 401(k)s and then have a separate RMD calculation and separate distribution requirement.

Speaker 1: Makes perfect sense, Jim. So, let's transition away from the basics and the basics are very important, they're foundational, and even the basics are complicated. But let's now transition away from that and start talking about strategy. What are some ways to reduce future RMDs and/or the related taxes?

Speaker 2: Well, the IRS has told us how much the RMD has to be. But remember the M in RMD, is minimum. So, all they've told us is the minimum amount that we have to take out. And, using my example, I'm required to take out five thousand for my IRAs this year. But what if I wanted to take ten or twenty thousand and pay the taxes? Well, you may say, Jim, why would you do that? I would do that if I thought I was in a lower tax rate environment now then I will be in the future. And we know that the, you know, the laws are scheduled to change on January 1st of 2026 with all of the tax brackets going up. And if I believe that's going to happen, I might want to take out twenty thousand or more than five thousand now because I'll be taxed on that amount in a lower tax bracket. If I wait, I'm just going to have to pay more taxes, potentially on taking out the same amount. A better strategy, what I really like Carlos, is converting these traditional accounts to Roth accounts. I bet our listeners, Carlos, are saying, why are these guys talking about RMDs now in the first quarter instead of waiting until the fourth quarter like we all do? Well, the reason is because of this conversion to Roth account and the new tax trap. Previously I might be able to take an RMD from one of my accounts, one of my IRAs, and then later convert it to a Roth account. Now, remember you can convert an RMD directly to a Roth, but my strategy, that might have been my strategy. The new rule is, I have to satisfy all of my RMD requirements before I do any Roth conversions. So, on my prior example of taking out five thousand, maybe I just took out some amount from one of my accounts, but I didn't take out my full five thousand. If I did a Roth conversion before that, I would run into a tax problem. So, it's important for our listeners to know they have to completely satisfy the RMD requirements before doing a Roth conversion. Let's talk quickly about what a Roth account is. This is an account funded with after tax money that can grow on a tax-free basis. I can take out the gains later in the future. I can always take out my contributions. But if I wait a certain amount of time, I can take out my gains and avoid taxes on that money, it'll grow income tax free. But the reason I'm bringing it up here is, there is no RMD requirements on the original account owner for Roth accounts. So, I can completely avoid any RMDs or taxes on that amount in the future. And like, I think we just alluded to Carlos, another strategy here is don't always wait until April 1st of the following year, even though you're permitted to do so, to take your first RMD because if I have to take two RMDs in one year, I may potentially push myself up into a higher tax bracket. Instead of spacing them out over two years and maybe avoiding that bracket creep and paying a lower tax bracket on the same amount.

Speaker 1: Right.

Speaker 2: So, that's a strategy. But, Carlos, now as I'm thinking about this, there are a number of people who just don't need the income. They're required to take it out, but they don't need it to pay expenses. Why don't we shift gears a little bit and talk about planning around those RMDs. What do we do if we don't need the income? Can you think of some ideas?

Speaker 1: Definitely. So, let's talk about, you know, how to plan ahead for RMDs with an annuity. Then if we don't actually need the income, let's talk a little cash value life insurance or maybe gifting the RMD. But let's start with the annuity conversation. So, imagine that you're using your traditional IRA or even consolidating a couple of IRAs to fund an annuity. And you start taking a five percent guaranteed distribution for life using an income rider. And now, five percent is relatively low in this environment. We're in a high-interest rate environment, we're actually closer to six percent on many of our AuguStar products. But, in any case, you might start this lifetime income before your RMDs are actually necessary. Right. What did we say? Seventy-three is the RMD age currently. But maybe you start your income rider at age sixty-five. So, this will help lower your future RMD amount as your account value is tapered by those withdrawals. And, secondly when your RMD phase does begin at seventy-three or maybe seventy-five, you're guaranteed an income may satisfy those RMDs. So, you don't have to worry at least in the first several years. But there's a chance that later on in retirement your RMD will be greater than your annuity income. Luckily, AuguStar is RMD friendly, meaning you can take the greater RMD amount without jeopardizing your living benefit, especially in a high-interest rate environment, Jim. Annuities may be worth considering to lock in a strong income, while planning ahead for RMDs. Now, that's an income conversation, but as you had mentioned, what if a client doesn't need the income? What are some strategies around cash value life insurance for example?

Speaker 2: Great question. Let me use you, Carlos, as an example. Let's say you're seventy-four and your RMDs have kicked in and you need to be taking them, but you don't need the money. How about if you purchase a cash value permanent life insurance policy on your own life that you will own? This is going to provide tax deferred growth of values in an income tax free benefit. Now, the cash value the policy provides you, Carlos, a lot of living benefits. You can access the cash value, which grows on a tax deferred basis, and you can access it on an income tax free basis as long as the policy is not a MEC, a modified endowment contract. Now, next you'll be able to leave a death benefit to your heirs that's income tax free. Now, if you left them the same retirement accounts, those are going to be taxed. And as we just talked about there's going to be some RMD requirements. And we'll get to inherited accounts in a minute. If you left a death benefit to your beneficiary, they won't have that issue. There's going to be no requirement for the beneficiary to spend the death benefit in any amount of time or deplete it even if they don't need the money. You might put that life insurance policy in a trust, which is going to offer some additional creditor protection. Let's say, Carlos, you had a federal estate tax liability problem. If you put that policy in an irrevocable trust, and Advanced Planning can help you with that, give us a call, you might avoid any kind of estate or federal estate taxes on that death benefit. You cannot do that with retirement accounts. So, I really prefer this leaving a death benefit to my beneficiaries over leaving them retirement accounts. You also mentioned gifting. You know the IRS permits you to make a qualified charitable distribution. In 2025, it will be one hundred and eight thousand. And what this means is as long as you make this transfer from your accounts directly to a qualified charity, so in other words Carlos, you never touch that money. You can exclude it from your gross income on your tax return. Now, by excluding it, this means you can take advantage of this. You don't have to pay any taxes on that one hundred and eight thousand, and even better, you don't have to itemize because of the exclusion from income to take advantage of the strategy. I would point out too, even though RMDs are not required for anyone until they turn seventy-three, a QCD is permitted for those seventy and a half or older. So, if you're charitably inclined, you might start making those distributions when you turn seventy and a half. That's going to lower your RMDs and all of your future taxes, especially for people who don't need the income. But I just mentioned the life insurance and inherited accounts. I really want to spend some time on that, Carlos. Would you mind taking us through the inherited account rules, how are RMDs calculated, you know, before and after death, does it matter who you are leaving your account to, how do these rules work?

Speaker 1: Yah, Jim, you know, this is arguably one of the most confusing aspects of RMD rules, is RMD rules for inherited accounts. Let's kind of break it down into a couple of different categories. Right. Let's start with beneficiaries who are not eligible designated beneficiaries. And we'll explain what that is in a second. But, for non-eligible designated beneficiaries there's really two categories. The first is if the original account holder had not started RMDs. Or had not started RMD age and they pass away and the beneficiary inherits the account. They are subject to the out in ten rule. Out in ten years. This means that by the end of the tenth year after inheriting the account, the account has to be totally liquidated. They don't necessarily have to take any distributions during that ten-year period, but maybe they should. Especially if they would like to stretch out the tax consequence. Right. Otherwise, they'll have one big tax bill when they liquidate the entirety of the account at the end of the tenth year. So, that's if the original account holder had not started RMDs. But what if they had started RMDs, and then they passed away, and now the beneficiary inherits the account? Well, as a rule of thumb, once RMDs start, the IRS doesn't want RMDs to stop. And so now, the beneficiary is subject to what some folks call the hybrid rule. So, Jim, what the hybrid rule is, the beneficiary must continue to take RMDs, but now based on their own life, if they're younger. But, still adhering to that out in ten rule. So, they'll basically take those RMDs and then by the end of the tenth year they have to liquidate the account. That's the hybrid rule. Now, we were just talking about two scenarios for a non-eligible designated beneficiary. Let's now talk about eligible designated beneficiaries. Well first, what is that? An eligible designated beneficiary falls into one of five categories: number one is surviving spouse, number two a minor child, number three a disabled individual, number four a chronically ill individual, and number five an individual that is not more than ten years younger than the deceased. Think of a younger sibling, two or five or seven years younger than the original account holder, but not more than ten years younger. So, these are folks who have a special advantage. They can stretch out the tax consequence over their life expectancy, the stretch method, which was previously available to all qualified account beneficiaries, but no longer is unless you're an eligible designated beneficiary. So, a very big advantage. Now one caveat to that, Jim, is minor children. So, they do have to switch over to the ten-year rule once they reach age of majority which varies by state. But once they reach age of majority the clock starts on that out in ten and by the end of the tenth year the entire account does have to be liquidated. And finally, what about not individuals, like an estate. If an estate inherits a qualified account and RMDs had not kicked in for the original account holder, they're subject to the old school rule of out in five. Right. Works just like the out in ten, except as the name implies, you have to liquidate everything by the end of the fifth year unless RMDs had already kicked in for the original account holder. Then, remember the rule, the IRS does not want RMDs to stop. So, the estate has the benefit of stretching out the tax consequences over the decedent's life expectancy. But remember with the stretch, Jim, you have the option to liquidate the account at any time. The stretch is just to continue to defer the bulk of the account value. But all that being said, Jim, what are some ideas that you have around these inherited account situations?

Speaker 2: Well, Carlos, first of all, these rules are very complicated, and I think you explained them in a very clear way. But, if I'm leaving an account, a traditional account to my heirs, I don't know that I want them messing and trying to comply with all of these rules. They only seem to be getting more complicated. So, let's first talk about a Roth conversion. You know, as I mentioned before, Roth accounts don't have any RMD requirements. If I anticipate that my heir is going to be in the same or lower income tax bracket, maybe a higher tax bracket, you know, they should be talking to financial advisors. But one strategy would be convert my account to a Roth account now and just leave the Roth account to my heir. There is none of this, because there were no RMD requirements for me, we don't have to look into the rule about whether RMD requirements were required or not. It's a simple requirement here and that is there's no RMD requirement in the first nine years, the account, the new owner of the account, has to liquidate it on the tenth year. And again, we don't care when we do because there's no taxes on that liquidation. It's growing income tax free the entire nine years. So, I really like that strategy. It avoids all of these complicated RMD rules. Second option that

I like even better is the life insurance and let me quickly recap a couple bits of this. So, if I could maybe convert some of my accounts to Roth accounts and then take the balance and buy life insurance. It's going to grow on an income tax free basis for me that I can use during my life and the death benefit that goes to my beneficiary isn't going to be subject to any of these RMD rules that you just discussed and went through. There won't be any cost penalties for failing to take out money and the IRS forcing you to take it out even when you don't need it. If you leave it in a trust, you can have some control from the grave. You know, maybe put some requirements on the trustee as to when they can distribute the money. Include a spendthrift clause in your trust so the creditors can't access it. As I mentioned, you know, with proper trust planning, all of those funds can avoid any kind of estate or federal or state estate taxes. We avoid the forced distribution. I just really like it. Especially the peace of mind knowing, Carlos, that I'm leaving a death benefit I pretty much have a good idea of what that death amount, benefit amount is going to be that goes to my heirs. I don't know what my retirement is going to be when I finally die and leave it to my heirs. You know, I've got a lot of market volatility issues that I have to be concerned with. I have peace of mind leaving a guaranteed death benefit or death benefit that I have a pretty good amount what it's going to be. With that, Carlos, why don't you take us out. Give us some planning ideas. Or what should our agents be doing right now?

Speaker 1: Definitely. I think the big picture here, Jim, is that there's not, there's really not a better time to start planning for RMDs. You know whether you want to reduce the amount of these RMDs in the future like we talked about or the taxes on them. Or whether you want to pursue alternate uses for the RMD funds. Income will not be needed when the RMD is due. And there are also alternatives to leaving taxable retirement accounts to heirs. And now may be the best time to consider moving those accounts into income tax free financial products that can be used to benefit your heirs for years to come. And so, our listeners will benefit greatly from getting with a financial advisor, financial planner, and planning ahead for this kind of stuff. But all in all, Jim, I really appreciate the conversation today. Our listeners can learn more about RMDs by checking out our comprehensive RMD guide.

[Music begins]

Speaker 1: And again, thank you everybody for tuning in today. And we look forward to working with you in the future.

Speaker 2: Thanks, Carlos.

Speaker 1: You got it. Thanks, Jim.

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