Facing large RMDs from your IRA?

By Jon S.

Oftentimes, we taxpayers focus too much on saving on taxes today, which can thrust us into higher tax brackets down the road. The best way to optimize taxes over the long run might be to accelerate taxes in the short run.

If you're approaching 72 years of age, consider the eventual impact of Required Minimum Distributions (RMDs) on your financial life. RMDs are forced distributions from your IRA account that result in taxable income for you. If your retirement account balance is large enough ($1 million or more), you might be bumped into a higher tax bracket as a result. Here are five strategies to reduce the impact of potentially large RMDs:

- **Qualified Charitable Distribution (QCD)** - We've written about these before. They allow you to direct up to $100,000 per year from an IRA to a qualified charity (or charities) while avoiding income tax on these monies and still going toward your RMD for the year. These are only available if you are 70.5 years or older.
- **A donor-advised fund (DAF)** - Another avenue to stretch your charitable giving. DAFs work best when you contribute highly-appreciated investments, but a DAF can also be funded with cash. While you can't do a QCD (see above) to a donor-advised fund, you can take an IRA distribution and put a portion of this into the DAF (if you don't have any highly appreciated investments to use). This would help offset some of the additional income recognized from an IRA distribution by allowing for a charitable deduction. With the new standard deduction amounts, you'll want to talk with your accountant before going down this path.
- **Consider taking IRA distributions before age 72** - If you retire at age 66, you will likely have 3-4 years of reduced income that would allow you to take IRA distributions to fill up your lower tax brackets. You could even delay Social Security benefits until age 70 and use IRA distributions to cover living expenses in the meantime. The benefit to doing so is that your SS benefits increase by 8% per year between 66 and 70. If you're not yet 60 years old, you might consider Substantially Equal Periodic Payments (SEPP). With this method, you can begin taking IRA distributions before you turn 59.5 without the normal 10% early withdrawal penalty. Talk to a Lead Advisor if you're interested in learning more.
- **Partial Roth conversions** – Similar to the above bullet point, if you're retired but have several years before RMDs kick in, you might consider converting a portion of your IRA monies to a Roth IRA. To make this strategy work, you'll want to pay the income tax with non-Roth conversion monies, i.e. out of pocket. Talk with your accountant about filling up the lower income tax brackets in each tax year until you begin RMDs. This approach reduces your IRA balance (and eventual RMDs) and may help you avoid being bumped into a higher bracket later. Roth IRAs are great estate planning tools, too, because they don't have required distributions.
- **Still working and contributing to your 401(k)?** If your plan offers a Roth option, and you have significant amounts in the traditional 401(k) already, consider switching all your future contributions to the Roth side. This will give you some tax diversification down the road.

There are other options as well, including using an IRA distribution to fund your HSA account or rolling an IRA into your 401(k) if you plan to work past age 72. Again, most of this advice falls under the category of tax planning. Please consult your accountant to discuss any of these strategies to reduce your future RMDs or limit the tax hit from current RMDs.

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