Retired Investor

A series devoted to the issues that face investors in retirement.

Determining When to Switch to the RMD

The decision as to how much to withdraw from a retirement portfolio is complicated not only by longevity risk, but also by tax issues. The commonly cited 4% withdrawal rate can be trumped by the Internal Revenue Service's (IRS) required minimum distribution (RMD) rules for retirement plan accounts. Determining which withdrawal rate to use requires an understanding of the RMD rules and a calculator.

The Required Minimum Distribution

An RMD is the annual minimum amount a retirement plan account owner must withdraw beginning in the year he reaches 70½. An individual can delay the RMD if he retires after age 70½. However, if an individual holds an individual retirement account (IRA) or owns 5% or more of the business sponsoring the retirement plan, an RMD must be taken starting the year the individual turns 70½.

Most, but not all, retirement accounts are subject to the RMD rule. RMDs must be taken from traditional IRAs and IRA-based plans such as SEPs, SARSEPs, and SIMPLE IRAs. Also subject to the RMD are all employer-sponsored retirement plans, including profit-sharing plans, 401(k) plans, 403(b) plans and 457(b) plans. Funds held in a Roth IRA are not subject to RMDs as long as the account holder is alive, but funds held in a Roth 401(k) account are subject to RMDs. If you have questions about whether a specific retirement account is subject to required minimum distributions, contact a tax professional.

If the RMD is taken from a tax-deferred account, the distribution is taxable in the year it was taken. If the full RMD is not taken, the amount not withdrawn is subject to a 50% tax.

Calculating the RMD

The required minimum distribution changes every year based on an account holder's age. It is calculated by dividing the account balance at the end of the immediately preceding calendar year by a distribution period. The distribution period is published by the IRS in its Uniform Lifetime Table. A retiree who is 70½ and has a spouse not more than 10 years younger will have a distribution period of 27.4. Assuming his traditional IRA account balance was $100,000 at the end of last year, his RMD will be $3,649.63 ($100,000 ÷ 27.4 = $3,649.63). This is the equivalent of 3.65% of his IRA balance.

A required minimum distribution must be calculated separately for every retirement account a retiree owns that is covered under the RMD rules. If more than one IRA is owned, the cumulative RMD can be taken from one retirement account. The same rule applies to individuals owning more than one 403(b) contract. RMDs from other types of retirement plans, such as 401(k) and 457(b) plans have to be taken separately from each account.

The IRS publishes two tables with distribution periods. The Uniform Lifetime Table is for unmarried retirees, retirees whose spouses are not more than 10 years younger or those whose spouses are not the sole beneficiaries of their IRAs. The Joint Life and Last Survivor Expectancy table is for retirees whose spouses are more than 10 years younger and are the sole beneficiaries of their IRAs. These tables are published on the IRS website.

Choosing a Distribution Rate

The 4% withdrawal rate is designed to be adjusted each year for inflation. A retiree starts by withdrawing 4% out of his entire retirement savings, regardless of the type of account those savings are held in, during the first year of retirement. Each year, the amount withdrawn is increased by the rate of inflation. Adhering to this strategy results in high likelihood of not running out of money before death, assuming a diversified portfolio is used. Early in retirement, following the 4% withdrawal rate will allow for a larger dollar amount to be withdrawn than if a rate based on the RMD is followed. The 4% rule is intended to encompass savings in all retirement accounts, including Roth IRAs.

As the retiree ages, the amounts withdrawn under the 4% withdrawal rate scenario change. Though the dollar amount withdrawn is increased by the prevailing rate of inflation, the increases may not be large enough to meet RMD amounts during a low to moderate inflationary environment. Using the withdrawal rates published in my article "Taking Retirement Withdrawals From a Fund Portfolio" (May 2013 *AAII Journal*), I found that the RMD became larger than the 4% adjusted withdrawal rate 11 years into retirement, assuming the person retired at age 65.

In a real-life scenario, the point at which the RMD becomes larger than the 4% withdrawal rate depends on many factors, including when a person retired, the rate of inflation

and the type of accounts held. The proportion of savings held in a Roth IRA can be a significant factor in making the determination, since they are not subject to the RMD rules.

The presence of an annuity adds another layer of complexity. Non-qualified annuities are exempt from the RMD rules, but an annuity held within an IRA is not. (Specific rules apply to annuities, and questions about them should be directed to a tax professional.) Plus, to the extent an annuity provides enough income, less than 4% may need to be withdrawn from other retirement accounts to meet living expenses. Pensions and Social Security benefits may also allow a retiree to lower his actual withdrawal rate below 4%. Conversely, some retirees may have no choice but to withdraw more than 4% to meet living expenses, even though that increases the risk of running out of money late in life.

Since so many factors can influence how much should be withdrawn from retirement savings, the decision as to whether to switch to basing the withdrawal amount on the RMD is one that needs to be revisited every year. Due to the complexity of RMD rules, there is not an easy way to determine the optimal withdrawal rate. One rule of thumb is that the more money that is held in accounts not subject to RMDs (such as Roth IRAs), the later in life a retiree will be forced to base their withdrawal amount on RMDs.

The IRS publishes a helpful list of answers to frequently asked questions about RMDs (www.irs.gov/Retirement-Plans/Retirement-Plans-FAQs-regarding-Required-Minimum-Distributions). On this webpage, you will find links to the distribution tables and worksheets for calculating your RMD.

—*Charles Rotblut, CFA, Editor,* AAII Journal

Feature: Stock Strategies

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1966 (Vietnam) and just barely in 2011 (U.S. debt ceiling and European debt). Excluding January's performance, the last 11 months of these years were up 24 times. The market's crash in 1987 is the additional blemish on the record. Eleven-month average gains are impressive at 12.3%.

In 2013, the S&P posted its 17th best January gain of all time, completing the indicator trifecta. The January Barometer, Santa Claus Rally and First Five Days indicators were all positive this year—increasing the odds, but not guaranteeing, positive returns for 2013. ▲

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Trading Strategies

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whether the periods of 2003–2004 and November 2007–February 2009 were mere blemishes on the survey's record as a contrarian indicator or a sign that both optimism and pessimism can remain at high levels for an extended period of time. I tend to think the latter will be the case, given long-term market history.

The failure of sentiment to work perfectly highlights two important points. Though correlations between sentiment levels and market direction have appeared in the past, the AAII Sentiment Survey does not predict future market direction. Overly optimistic and pessimistic investor attitudes are characteristics of market tops and bottoms, but they do not cause stock prices to change direction. Rather, it is changes in expectations of future earnings and economic and valuation trends that move stock prices. The timing of such changes has proven to be difficult to predict with accuracy.

This leads to my second concluding point: Never rely on a single indicator when forecasting market direction. Rather, consider a variety of factors—including prevailing valuations, economic data, Federal Reserve policy, government policies and other prevailing macro trends—and allow for a large margin of error in your forecast. As the saying attributed to John Maynard Keynes goes, the market can stay irrational longer than you can stay solvent. ▲

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