Financial Planning

10 common IRA distribution mistakes

By **Ed Slott** **May 06 2016**

The end of the year still seems far off for clients with individual retirement accounts who must take required minimum distributions by that time. But it's never too early to start planning for it.

The required beginning date for RMDs is generally April 1, following the year the client turns 70 1/2, but after that RMDs are due by the end of the year. For inherited IRAs, RMDs must generally begin during the year of death and be taken by the end of each future year.

There is a 50% penalty for any shortfall, but the Internal Revenue Service will generally waive the penalty for good cause, such as health issues or mistakes made by advisers or financial institutions. If an RMD is missed, it is essential that clients immediately make up the missed RMD and file Form 5329 with the taxes to report the missed distribution and request that the penalty be waived.

Most advisers know this, but mistakes still occur.

Here are many of the common RMD-based errors:

1. Multiple accounts subject to RMDs. Clients often have multiple IRA or plan accounts that are subject to RMDs. Make sure clients have taken all their retirement plans into account so nothing falls through the cracks.

Once all the accounts are identified, the next step is to organize them by category. For example, all IRAs should be grouped together, including traditional IRAs, SEP and SIMPLE IRAs but not Roth IRAs or inherited IRAs.

The RMD for each IRA should be calculated separately, but the total RMD for the IRA group can be taken from any one or combination of IRAs in that group. This is a special aggregation rule for IRAs, which also applies to

403(b) plans if a client has more than one of those.
However, an IRA RMD can't be satisfied from a company plan or vice versa. Each company plan's RMD must be taken from that plan only.

2. Inherited IRA RMDs. RMDs from inherited traditional IRAs can be combined only with other traditional IRAs inherited from the same decedent. The same goes for inherited Roth IRAs.

Although there are no lifetime RMDs from Roth IRAs, inherited Roth IRAs are subject to RMDs, so make sure that clients take them. The 50% penalty also applies to missed RMDs from inherited IRAs, even if they are tax-free, such as inherited Roth IRAs.

3. Company plan RMDs. Company plans are also subject to RMDs but there are a couple of exceptions.

One is the still-working exception. For those who have a 401(k) or some other employer retirement plan, the RBD is the same April 1 date as for IRA owners, unless they are still working for the company where they have the plan.

If they don't own more than 5% of the company, they may be able to delay their RBD to April 1, following the year they finally separate from service. This is sometimes called the still-working exception to the RBD, but it applies only to required distributions from employer plans and not to IRAs.

The rule also doesn't apply to employer plans if the client is no longer working for the company that offers the plan.

For example, Marc has an IRA, a 401(k) and a 403(b) plan and is still working for the company that sponsors the 401(k), and he doesn't own more than 5% of that company. Marc can delay distributions from his 401(k) until April 1 of the year following the year he separates from service, regardless of his age.

The April 1 date works the same as with an IRA, but the age exception doesn't. It does apply to 403(b) plans but only if the employee is still working for the employer that sponsors the plan.

A common mistake occurs when an employee is still working and thinks that the still-working exemption applies to his or her IRAs and doesn't take those RMDs. That incurs a 50% penalty on the missed IRA RMDs, even though the employee is exempt from the company plan RMDs.

In addition, there is also the old-money exception for 403(b)s. If a 403(b) participant has funds from participating in a pre-1987 plan, there is a grandfather rule that allows the participant to delay RMDs on that money — commonly known as old money — until age 75.

There must be a statement that clearly shows the balance as of Dec. 31, 1986, which will be readily available from most plans and may even be included with the current statement.

The standard April 1 RBD applies to all other amounts in the plan, including earnings on the pre-1987 balance. Due to attrition, this exception applies to fewer people each year, but advisers should still know about it.

4. Year-of-death RMDs. Death gets you out of pretty much everything in the Tax Code, except for RMDs. They still must be taken for the year of death.
A point of confusion is who is responsible for taking the year-of-death RMD, if it wasn't already taken by the decedent during the year.

In this case, it is the beneficiary who takes the year-of-death RMD and reports the income on his or her tax return. The year-of-death RMD doesn't go on the decedent's final income tax return (Form 1040) or on his or her estate income tax return (Form 1041), as even some CPAs believe.

The amount of the year-of-death RMD, however, isn't based on the beneficiary's life expectancy. For the year of death, the beneficiary takes the amount the decedent would have had to take had he lived.

The following year, the beneficiary calculates the amount based on his or her own life expectancy.

5. First-year RMD confusion. When clients take RMDs for the first time, the most common error is determining what balance to use to calculate the RMD and which age to use to make that calculation.

For the first year RMD, use the balance as of Dec. 31 of the year before the year the client turned 70 1/2, which is the client's first distribution year, even if the distribution isn't taken until the following year.

Clients have until April 1 of the year after their first distribution year to take their first RMD. After that though, all RMDs must be taken by the end of the calendar year.

6. Inherited IRA mistakes. If a client inherited an IRA in 2015, then the first RMD will generally be due by the end of 2016. However, there are special exceptions for spouses who inherit.

If there is more than one beneficiary, say three children, then the inherited IRA must be split by the end of the year into separate properly titled inherited IRAs in order for each beneficiary to take advantage of the stretch IRA based on his or her own life expectancy.
If the split is not done by the end of the year, then the RMDs for all beneficiaries will be based on the age of the oldest beneficiary or the one with the shortest life expectancy, and the younger beneficiaries will have to withdraw more than they otherwise would have.

When splitting the inherited IRA, use only direct transfers. A non-spouse beneficiary isn't permitted to do a rollover, so only a direct transfer will work.

Each properly titled inherited IRA should contain the name of the deceased IRA owner and identify the account as a beneficiary IRA.
7. Check 72(t) schedules. Advisers should know which clients are using a "series of substantially equal periodic payments" (known as 72(t) payment schedules) to avoid the 10% early distribution penalty.

These schedules must be followed precisely and not modified, otherwise the 10% penalty kicks in retroactively for all the prior year 72(t) payments taken before 59 1/2. Most clients are on a calendar year, though they don't have to be, so it is a good idea to check that their payments are correct before the year ends and mistakes occur.

8. Inherited plan rollovers. If a non-spouse beneficiary inherited an employer plan in 2015 and wants to roll those funds over to an inherited IRA or convert to an inherited Roth, that must be done by the end of 2015 to get the stretch IRA, and it must be done as a direct transfer to the inherited IRAs.

9. Check on lump-sum distributions. For clients who took lump-sum distributions during the year from corporate plans to take advantage of the net unrealized appreciation company stock tax break, make sure that all funds from the plan are distributed by the end of the year. Otherwise the lump-sum distribution will fail and the NUA tax break will be disallowed.

This could result in a huge unexpected tax bill if a large block of company stock was withdrawn in anticipation of using the NUA tax break.

10. Check beneficiary forms. The end of the year is a good time to check that all beneficiary forms have been updated with any changes during the year such as birth, death, marriage, divorce or remarriage. This is good planning and a good habit to get into. In addition, make sure clients know where their beneficiary forms are filed.

This story is part of a 30-30 series on preparing for retirement. This story was originally published on Oct. 1, 2015.