Taking RMDs in the form of stock

Clients don't have to sell stocks in their individual retirement accounts to take their required minimum distributions.

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Once again, clients are worried about taking required minimum distributions while the markets are in turmoil. This happened in 2008-2009 and again in 2020. In response to the 2008 market crash, Congress waived RMDs for 2009, and it did it again for RMDs in 2020 in response to Covid and the resulting market decline.

Congress seems to like waiving RMDs as a fix when the stock market falls. The waiver is very popular with constituents, and Congress likes that too. But waiving RMDs mostly helps those who don't need the help.

When the IRS proposed changing the life expectancy tables used to calculate RMDs (effective in 2022), it estimated that only about 20% of those subject to RMDs take the minimum because they must. That group doesn't need the RMD funds. The other 80% take more than the minimum because they need the funds. Waiving RMDs for this group doesn't help them since they will still need to withdraw funds from their individual retirement accounts for needed income.

From the IRS' Proposed RMD Regulations, Nov. 7, 2019: "Using confidential tax return data, the Treasury Department estimates roughly 4.6 million individuals, or 20.5% of all individuals required to take RMDs from an affected retirement plan, will make withdrawals at the minimum required level in 2021, and might reduce withdrawals as a result of the rule [the change in the tables]."

The other reason Congress waives RMDs when markets fall is that they hear the screams from their constituents that if the value of their individual retirement accounts decreases, they'll be forced to sell the stocks (or funds) in their IRAs at low values. Congress believes this and then waives RMDs. But this is not true.

We're already hearing this alarm bell again from advisers and the media. But you don't have to sell stocks in IRAs to take RMDs.

First, most people shouldn't have all their IRA funds in stock holdings. There should be enough liquid cash in the IRA to use for RMDs. Also, RMDs are a relatively small percentage for most IRA owners. For example, when RMDs begin at age 72, the RMD factor is 27.4 years, which comes to only 3.65% (100 /27.4 = 3.65%). An 80-year-old must withdraw 4.95%, and a 90-year-old, 8.2%.

But let's say clients don't have enough liquid funds in the IRA to meet their RMD obligation. They still don't have to sell IRA stocks at low values. Instead, they can use their stocks or funds without having to sell them. They can take the RMD amount in kind, as stock, by transferring the shares from the IRA to a regular taxable brokerage account. The stocks don't have to be sold.

Say the amount of the RMD is $5,000: They can transfer $5,000 of XYZ Inc. stock to their non-IRA brokerage account. They'll owe tax on the $5,000 and satisfy their RMD. The stock isn't sold, but transferred in kind, so they're still holding the stock, but not in the IRA anymore.

KEEP TRACK OF STOCK BASIS

If clients do take their RMDs in stock, though, they must keep track of basis so they can accurately compute the gain or loss when the stocks are sold. Any gains or losses that occurred while the stock was in the IRA are meaningless because there's no concept of gain or loss while funds are in the IRA.

The important value to keep track of is what the shares were worth when they were distributed (transferred out) from the IRA. That value becomes the new basis for determining the gain or loss on a future sale (except if the shares are held until death, when heirs receive a step-up in basis, eliminating the capital gain on lifetime appreciation).

EXAMPLE

Original cost of stock purchased inside the IRA: $2
Value of stock when transferred in kind to brokerage account: $10
Gain within the IRA (not recognized): $8
Value when stock is later sold: $15
Gain on sale: $5

Pam purchases ABC stock within her IRA for $2 per share. Years later, Pam needs to use that stock to take her RMD, which is $10. She transfers $10 worth of ABC shares to her taxable (non-IRA) brokerage account. Pam will owe tax on the $10 and satisfy her $10 RMD for the year. That $10 value becomes her basis for computing any future gain or loss.

Advisers should check to make sure the brokerage account statement reflects that basis ($10 for Pam) and not the original amount ($2) paid for the shares when bought within the IRA. The new "buy slip" (cost of the shares) is the value reported on Form 1099-R for the IRA stock distribution. Keep that 1099-R as substantiation for computing future gains or losses.

The holding period for long-term capital gain rates begins on the date of the distribution from the IRA, not the original date the shares were purchased in the IRA.

Years later, Pam sells the shares from her brokerage account at $15 per share. She reports a gain of $5 per share ($15 selling price, less her $10 basis). The $10 value on the distribution date is Pam's basis, not the $2 she originally paid for the stock when it was purchased in her IRA.

If Pam erroneously used that original $2 cost, she would end up reporting a gain of $13 (the $15 selling price less the $2 cost = $13 gain), but that would result in overreporting the gain by $8 per share. That $8 gain which occurred within the IRA was paid for by paying tax on the full $10 upon distribution from the IRA.

Tax reporting errors can work the other way too, if say the original cost in the IRA was higher than the eventual sale price. In that case, using the incorrect cost would result in an underreporting of the gain (or an overreporting of the loss) on the sale.

MARKET DECLINES

Another misconception about market declines and RMDs is that the decrease in share value will mean lower RMDs. No, it won't. The amount of the 2022 RMD is already locked in based on the value of the IRA on Dec. 31, 2021. If values decline in 2022, the 2022 RMD doesn't change, but the percentage of IRA assets that will have to be distributed to meet that RMD amount will be larger.

Let clients know they don't have to worry about selling shares of stock in their IRA to take their RMDs. Even if they don't have enough cash in their IRA to take their RMD, they can take that RMD in stock with in-kind distributions. However, if RMDs are taken in stock in a declining market, it will take more shares to satisfy their RMD.

Also make sure that clients maintain good records of stock values when shares are distributed from IRAs in kind. Keep the 1099-R as proof of the value on the IRA distribution date.