RMD and Dangerous? Not Really.

By Editor Test *Wed, Nov 18, 2009*

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Underdogs inspire my respect. I've always admired, for example, the Required Minimum Distribution. How did the RMD become the pariah of the tax code, the wolf at every septuagenarian's door?

Nothing so universally detested could be all bad, my contrarian instincts told me.

The RMD must surely suffer when people discuss Roth IRAs, just as cavemen suffer when they see GEICO commercials. Why does anyone convert a traditional IRA to a Roth IRA, except to avoid an RMD?

When someone first described the RMD to me, I was baffled. The U.S. government was apparently forcing senior citizens to move a fraction of their tax-deferred money to a taxable account, and to pay income tax on the amount they transferred.

It made no sense. Then someone explained it to me. The government wants its pound of flesh. In their youth, I was told, these poor retirees sold their souls for a paltry tax deduction, not realizing that the devil, in the shape of the IRS, would eventually claim . . . an RMD.

O.K., here's where I'm going with this: We shouldn't be thinking of the RMD as a pound of flesh. We should be thinking of it as an annuity.

In the United Kingdom, retirees have to convert their remaining tax-deferred savings (they get 25% of it tax-free at retirement) to an income annuity when they reach age 75. They don't call it a penalty or a curse. They call it an annuity.

Americans and their advisors should think of the RMD the same way, and integrate it with their retirement income plans. The RMD schedule is designed to stretch tax-deferred savings over a lifetime—a long lifetime. You withdraw about 3.6% of your money the year after you reach age 70½. By age 78 you're taking out about 5%. At age 83 you take out about 6%. If you make it to age 90, you'll be taking out 10% a year.

Resentment toward the RMD is understandable. If someone doesn't need the income, the RMD is simply an annual tax bill from Uncle Sam. One 82-year-old I know always mails his distribution to his adult kids, just to get the damned thing off his hands. It's tainted money.

But if retirees need the income, as most of us will, the RMD is a healthy part of life. It's money we can look forward to. If a retiree needs the RMD for living expenses, he or she probably isn't paying a very high marginal rate of income tax on the distribution. No cause for resentment there.

If you don't need the income, do the sportsman-like thing. Appreciate the value of the tax-deferral that you enjoyed for all those years and pay the income tax. If the distribution threatens to push you into a higher tax bracket, make a contribution to charity.

I don’t like taxes any more than you do. But the RMD isn’t a tax. It’s an annuity. It has a specific public policy purpose: to ensure that people use their tax-deferred savings for retirement income rather than as a bequest. Tax deferral would make no sense without it.

That’s why it’s not entirely accurate to say that 401(k) owners are up a creek without a paddle when it comes to converting their defined contribution accounts to lifetime income. There’s the RMD. Sure, it’s crude. But would you prefer the British approach? If we didn’t bash the RMD, maybe more people would contribute to their 401(k)s and IRAs.

Personally, what concerns me more than taxes or RMDs is the abuse of language. We kick language around. We disrespect it. Characterizing the RMD as a government clawback and not an annuity is a corruption of language. And a corruption of language is a corruption of thought. You might even say that language is an underdog. It’s one that inspires my utmost respect.