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Retirement Distribution Pitfalls: Not Reinvesting RMDs You Don't Need

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Accumulation is a key facet of reaching your retirement goals. However, we tend to see far less about portfolio drawdown, or decumulation—the logistics of managing a portfolio from which you're simultaneously extracting living expenses during retirement. This can be even more complicated than accumulating assets.

Pitfall: One of the big mistakes of retirement distribution can be not reinvesting RMDs you don't need. Retirees may experience a situation where the amount they must withdraw from 401(k)s and IRAs for required minimum distributions can take them over their desired distribution threshold. The RMD rules require that people initially withdraw less than 4% of assets at age 70 1/2, but distributions can quickly step up into the 5%, 6%, and 7% range.

Workaround: What people might not realize is that there's nothing saying they have to spend their RMDs; they can reinvest in a taxable account if they'd like that money to stay invested in the market. This can be a wise strategy for retirees who are concerned with legacy planning or long-term care needs down the line. It's possible to build a taxable account that has many of the tax-saving features of a tax-deferred account.

401(k) plans and IRAs are long-term retirement savings vehicles. Withdrawal of pre-tax contributions and/or earnings will be subject to ordinary income tax and, if taken prior to age 59 1/2, may be subject to a 10% federal tax penalty. Funds in a traditional IRA grow tax-deferred and are taxed at ordinary income tax rates when withdrawn. This is for informational purposes only and should not be considered tax or financial planning advice. Please consult with a financial or tax professional for advice specific to your situation.

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Advisor Corner

Mr. Kennedy's investment philosophy is the same that he has practiced over the last decade: securities markets are efficient and advisors primarily add value by coordinating the asset allocation for clients based upon risk tolerance, objectives, and time horizons. The firm has constructed 5 models for clients that vary in risk to meet the goals of each client. The firm primarily uses passive mutual funds in each model and uses select actively managed funds for bond, commodity, and real estate exposure. ITI uses several research resources, including many that were used over the last 20 years, to assist with the recommended asset allocation and the appropriate funds to utilize in each model. Mr. Kennedy is an Investment Advisor Representative of ITI Financial Management, LLC.

Investment services are offered through ITI Financial Management, LLC, a registered investment adviser with the state of Missouri

Avoid These Mistakes With Your IRA, Part 1

ITI Financial Management/Troy E. Kennedy

- ITI Financial Management is a fee only, non commissioned registered investment advisory firm headquartered in Springfield, Missouri. We presently manage approximately $65 million for over 175 accounts. In November 2009, Springfield Trust & Investment Company sold to a large out of town bank holding company. After 17 years as a shareholder/executive vice president with Springfield Trust & Investment Company, Troy Kennedy founded ITI Financial Management to continue to provide the highest level of personalized investment management and financial planning services. There are no fees to hire ITI nor are there any fees to terminate the relationship. It is truly a partnership with each client.

Funding an IRA may seem like a simple financial task: Pick your provider, send in your money, and choose your investments. Done.

But a look at Internal Revenue Service Publication 590, which details the ins and outs of IRAs, suggests there's more to it. There are two key IRA types (Traditional or Roth), as well as two subtypes of Traditional IRAs (deductible and nondeductible), not to mention byzantine rules regarding rollovers, conversions, and recharacterizations. And what about when you begin taking IRA withdrawals in retirement? More kooky rules there, too.

There are a few obvious IRA mistakes, such as pulling money out of a Traditional IRA before age 59 1/2, but here are some IRA pitfalls that might be less familiar.

Mistake 1: Not taking full advantage of the tax benefits. One of the key benefits of any type of IRA, whether Roth or Traditional, is the ability to avoid taxes as the money grows. Investors who hold stocks and bonds in a taxable account are likely to receive taxable income and capital gains distributions from their holdings each year. Investors who hold the assets in an IRA, by contrast, have the potential to be taxed at a lower rate, or not at all, on those payouts, assuming they don't take the money out prior to age 59 1/2. That represents an opportunity to stash high-income-producing securities, such as dividend-paying stocks, for example, within the IRA wrapper, while saving more tax-efficient assets, such as broad market equity index funds, in taxable accounts.

Mistake 2: Being dogmatic about asset location. The key consideration here is when investors expect to need the money. For young accumulators, IRAs may be stock-heavy, and there may be no reason to add income producers into the mix. Meanwhile, for a 35-year-old holding bonds to fund a remodeling project, for example, it may make more sense to hold them in a taxable account, without any strictures to withdraw the money before retirement. The same reasoning applies to retirees who would like to pull some money for living expenses from their taxable accounts. It doesn't make sense to have all of the bonds residing in an IRA; bonds' relative liquidity might be helpful in taxable accounts, too. Finally, it's worth noting that it's often desirable to tap Roth assets toward the back end of retirement—if at all—because their tax-saving features are generally the greatest and should be stretched out for as long as possible.

Mistake 3: Not giving due care to IRA beneficiaries. The importance of beneficiary designations (they actually trump other bequests laid out in estate plans) is an under-discussed topic. As with any type of beneficiary designation, it's important to keep your IRA beneficiary designations up to date as your life situation changes—marriages, divorces, parents passing away, and so forth. Most people will name their spouses as their IRA beneficiaries; when the account owners die, their spouses can generally roll the assets into their own IRAs.

Mistake 4: Triggering a tax bill on a Roth IRA withdrawal. One of the key benefits of funding a Roth IRA is the ability to take tax- and penalty-free withdrawals in retirement. The Roth may also be a great vehicle for accumulators who worry about tying their assets up for a long time, as it's possible, under certain conditions, to withdraw contributions at any time and for any reason without triggering taxes or a penalty. Things get more complicated, however, when it comes to withdrawing investment earnings, or if your money got into the Roth because you converted it from a Traditional IRA or 401(k).

Mistake 5: Triggering a tax bill on a rollover. When it comes to the financial tasks that might crop up on your to-do list during your investment career, an IRA ranks as easy on the degree-of-difficulty scale. But it's still possible to goof up a rollover.

Avoid These Mistakes With Your IRA, Part 2

ITI Financial Management/Troy E. Kennedy

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One of the key rules to bear in mind when rolling over money from a former employer's 401(k) into an IRA is the 60-day rule—that is, you have 60 days to complete the rollover. If you don't complete the rollover within that 60-day window and you're younger than 59 1/2, the amount will be treated as an early distribution and be subject to taxes and a 10% penalty. That's why it's a good idea to have your providers deal with one another on the rollover. That way, you never put your hands on the money, and the financial-services providers know the need to complete the rollover in a timely fashion.

Mistake 6: Letting your brokerage or fund company call the shots on your RMDs. Investors who are age 70 1/2 know that that's the year in which they must begin taking required minimum distributions from their Traditional IRAs and 401(k)s. Those RMDs are taxable. But RMD season also gives you the opportunity to make lemonade by being strategic about the investments from which you pull the distributions. Did your stock holdings shoot up in 2013? If so, it may be an ideal time to trim those holdings to restore your asset allocation back to your targets. As long as you take the right amount of RMDs from all accounts of a given type (you can't mix and match RMDs from your 401(k) and IRA, for example), you'll be on the up and up with the IRS. By contrast, if you leave it to your brokerage fund company to decide where to pull the money from, it may not be to your advantage. They may pull the money in accordance with their default rules, often proportionally from each holding.

Mistake 7: Not appealing a penalty on missed RMDs. Fail to take the RMD, and you'll be on the hook not just for the taxes, but also a 50% penalty (excise tax) on the amount that you should have taken and did not. That said, there may be legitimate reasons that you (or a loved one) missed the RMD. Perhaps you were ill, for example, or perhaps your parent is in the early stages of dementia and you haven't yet implemented a system to help with financial matters. The first step is to take the required distribution as soon as possible. Then fill out IRS form 5329, requesting a waiver of the 50% excise tax on missed distributions and providing the reason. Assuming the IRS finds that the missed RMD owes "to reasonable error and you are taking reasonable steps to remedy the shortfall," you should be able to get that penalty waived.

Mistake 8: Spending RMDs you don't need. In addition to the taxes due on RMDs, many retirees grouse about the distributions because they're taking them over their desired distribution rates. Shortly after they commence, RMDs quickly escalate well above the distribution rates that much research deems prudent and up into the range of 6% or 7%. Of course, as retirees age, they can arguably take more from their portfolios than they could earlier in their retirement years because their life spans are shorter. Additionally, your IRA may not be your only retirement resource; you can forgo distributions from other account types so that your RMDs don't take you over your planned spending rate. But if the RMD requirements are going to take you over your planned distribution rate, you can reinvest the money back into your retirement accounts—either a taxable account or a Roth IRA.

401(k) plans are long-term retirement savings vehicles. Withdrawal of pre-tax contributions and/or earnings will be subject to ordinary income tax and, if taken prior to age 59 1/2, may be subject to a 10% federal tax penalty. Funds in a traditional IRA grow tax-deferred and are taxed at ordinary income tax rates when withdrawn. Contributions to a Roth IRA are not tax-deductible, but funds grow tax-free, and can be withdrawn tax free if assets are held for five years. A 10% federal tax penalty may apply for withdrawals prior to age 59 1/2. This is for informational purposes only and should not be considered tax or financial planning advice. Please consult a tax and/or financial professional for advice specific to your individual circumstances.

Inflation Can Vary by Category

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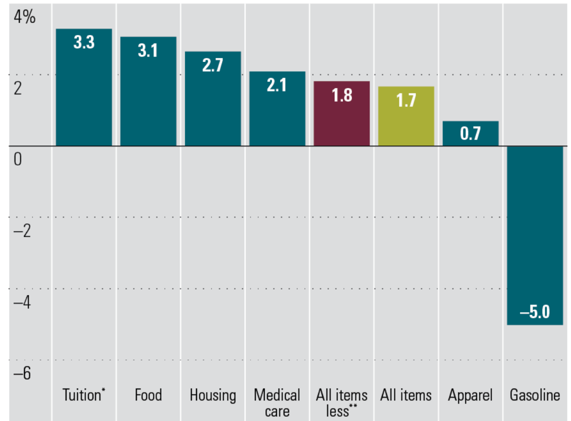
The general inflation number (the "All items" category) may be a good measure for the economy at large, but the cost of certain goods and services could rise much faster than the average cost of living.

For the past year, tuition, food, housing, and medical care have all experienced much higher inflation rates than the headline number. Gasoline prices, on the other hand, have been declining and are now near four -year lows.

People who need to focus on savings for college or medical care may be left short, as the cost for such items often tends to rise at a faster rate than the average cost of living. Those investors might not be able to keep pace with rising costs if they do not take their real inflation rate into account when planning their investment goals.

Consumer Price Index Components, Year-Over-Year Change



*other school fees and child care **less food and energy

Source: Bureau of Labor Statistics, Morningstar calculations.
Data as of October 2014.