MarketWatch

THE BEST PRESCRIPTION FOR RMD WOES

By JACK TATAR July 21, 2015

My accountant likes to remind me that I shouldn't be upset that I have to pay more in taxes in a given year. It just means that you've made more money, he tells me, and how can you be upset by that?

Well for someone like myself, who's still working and can manage these fluctuations, it's not a big deal. But for people who are in retirement, the impact of investing success results in unexpected higher required minimum distributions, or RMDs, that can significantly impact their income levels and nest eggs.

I recently spoke with James Merklinghaus of JM & KM Wealth Management and he described a situation that he's seeing more of with his clients:

"I had a retired couple come to me because the upcoming tax hit on their required minimum distribution seemed incredibly unfair. Here they were, both still freelancing in their dream professions, in fabulous health, and with a brood of kids and grandkids they had hoped to leave an inheritance to. They had forgotten about the RMD on their combined half-million dollar 401(k)s and IRAs, and they saw their future and that of their heirs quickly disappearing in checks made out to the IRS," Merklinghaus recounted.

Merklinghaus does point out that these clients were in the enviable position of not needing to spend their retirement money, and instead wanted an investment strategy to minimize and delay taxes. But for other clients, who depend on a level flow of income, the tax bite of RMDs can provide for unplanned fluctuations that could lead to an impact on their lifestyle.

Fortunately for Merklinghaus and his clients, he uses his experience to work with his clients before retirement by designing strategies that address their specific situations and consider RMDs into all planning scenarios. Because of that, he may use different strategies to counter the potential impact of RMDs for clients.

"In this couple's case, they didn't need the income from the RMD yet, and they didn't want to pay the forced taxes — that's the perfect set-up for a qualified longevity annuity contract (QLAC)," Merklinghaus said.

QLACs came on the scene a few years ago precisely for people who wanted to keep investments in place, tax-free. In 2014 it was an investment approved by the Department of the Treasury and the IRS to use inside 401(k)s and IRAs.

You don't want to mess with the RMD because the penalty for failing to take the RMD is 50% of what you should have taken out, plus the tax. If this couple had failed to take their combined RMD of $30,000, they would have owed a $15,000 penalty, plus taxes on $30,000. Instead, they were able to invest in a QLAC, and defer paying taxes on the money until they turn 85, when they will be in a more favorable tax bracket.

With a QLAC, participants can defer $125,000 or 25% of the account balance (whichever is less). This reduces the RMD each year during the deferral period and the tax due on that amount of distribution.

There are some restrictions with a QLAC, but if you have concerns about RMDs, it may be something to discuss with your financial adviser.

Another approach that Merklinghaus uses where appropriate is the "stretch IRA," which isn't a type of individual retirement account, but rather it is a feature used in estate planning or a financial strategy that allows people to stretch out the life — and therefore the tax advantages — of an IRA.

Having a problem with RMDs might seem to be an enviable position, but discussing these options with your financial adviser can provide options to consider.

Jim Merklinghaus, owner of JM Wealth Management, ranks among the most highly-qualified insurance and financial professionals in the New Jersey/New York metropolitan area. With almost 30 years of experience, Jim helps individuals and institutions by providing solid answers, practical solutions and tailored advice.

For more information, visit www.jmwealth.net or call 201-723-4926.