Smart strategies for required distributions

Fidelity Viewpoints

You saved smartly for retirement—contributing to a traditional 401(k)s or IRA to give your savings the chance to grow tax deferred until you retired. Now the time to take that money out is here. Every year, once you are age 70½ or older, you generally need to withdraw a certain amount of money from your traditional IRA, 401(k), or other workplace savings account. It is important to determine how these minimum required distributions—known as MRDs or RMDs—fit into your retirement income plan.

"Making the best use of your MRDs can help avoid costly mistakes. If you don't absolutely need that money for living expenses, you can make some decisions about the best way to use it," says Ken Hevert, Fidelity senior vice president of retirement products.

Four key questions

1. Do you need the money to cover living expenses?
2. Do you plan to reinvest the money?
3. Do you plan to pass assets on to your heirs?
4. Do you want to make charitable donations now?

While the IRS requires you to take MRDs, you have some flexibility on timing and what to do with the money. For instance, if you do not need it for living expenses, you may want to give it to your heirs or a charity, or reinvest it.

It is also important to keep in mind that MRDs are usually taxed as ordinary income. Although, if you have made after-tax contributions to these accounts, part of the distribution may be nontaxable. Also, Roth IRAs and Roth 401(k)s do not have MRDs during your lifetime.

Here are four key questions that can help you come up with an MRD strategy.

1. Do you need the money to cover living expenses?

"If you're planning to spend your MRDs, one big consideration is managing your cash flow," explains Hevert. "You may want to consider having the money sent directly to a cash management or bank account that provides easy access to the money."

Having the money automatically distributed to a cash management or taxable brokerage account also helps to ensure that your MRD requirement will be met by the deadline of December 31 each year, avoiding an IRS penalty on missed or underfunded distributions.

When planning your budget, bear in mind that you'll generally owe income tax on any MRDs and other distributions from traditional retirement accounts. You can have taxes automatically withheld from your MRDs. If you choose not to do this, make sure you set aside money for tax time, and be careful—sometimes under withholding can result in a tax penalty. There are a few different withdrawal methods that you may want to consider to help you meet your MRD requirement:

Annual recalculation: This approach generally requires annual distributions from your account based on your life expectancy. It is recalculated each year.

Purchasing an income annuity: The purchase of an annuity can help turn your IRA assets into a stream of income payments that's guaranteed[1] for life; this takes care of MRDs at the same time.[2] (There are a number of limitations on the types of annuities that can be used to satisfy MRDs, so be sure to check with a tax professional.) Additionally, only the amount used to purchase the annuity may satisfy your MRD requirement. If you have other IRA accounts, you will still need to meet required distributions for them.

Annuities have advantages—most eliminate the need to worry about outliving your money, for one—but also drawbacks, such as the loss of access to your principal. Weigh the purchase of an annuity carefully, and do so in the context of a broader retirement plan. There are two payment options:

- **Fixed payment option:** Lifetime payments remain level—although you may choose to pay extra for a cost-of-living adjustment (COLA) to increase payments annually and to help hedge against inflation. However, access to additional principal withdrawals is limited. You could also use a Qualified Longevity Annuity Contract (QLAC) to defer payments on a portion of your pretax assets up to age 85 to help cover expenses later in life.
- **Variable payment option:** Lifetime payments vary over time, based on the performance of the underlying investments you choose. In some cases, additional withdrawals after purchase may be allowed.[3]

2. Do you plan to reinvest the money?

If so, you may want to consider having any MRDs routed to one of your nonretirement accounts, where you can invest the money according to your goals, time horizon, risk tolerance, and financial circumstances.

If you invest your MRD in a taxable account, you may want to consider owning tax-efficient securities to help potentially reduce your tax liability. These could include:

Municipal bonds and municipal bond funds. These pay income that is free from federal income tax and, in some cases, from state and local taxes. Note: Income from some municipal bonds and mutual funds is subject to the federal alternative minimum tax.

Stocks you intend to hold longer than a year that may pay qualified dividends. Sales of appreciated stocks held more than a year are taxed at lower long-term capital gains rates. Just be sure any dividends the stock pays are qualified. Qualified dividends are taxed at the same low rates as long-term capital gains, but nonqualified ordinary dividends, such as those paid by many real estate investment trusts (REITs), are taxed at ordinary income rates.

Exchange-traded funds (ETFs) and tax-managed mutual funds. The unique structure of many ETFs may help investors by enabling them to delay realizing taxable capital gains. Tax-managed and other tax-efficient stock mutual funds, such as index funds, trade infrequently and may use other techniques that seek to reduce a shareholder's tax liability.

You may want to consider owning less tax efficient investments like taxable bond funds, REITs, or dividend-paying stocks in tax-advantaged accounts like IRAs or tax-deferred workplace savings accounts.

Remember to choose an asset mix that reflects your financial situation, time horizon, and risk tolerance. "Know what the purpose of the money is, how long until you'll need it, and how much risk you're willing to take—and invest accordingly," advises Hevert.

3. Do you plan to pass assets on to your heirs?

If so, you may want to consider converting traditional IRA assets to a Roth IRA: If you do, you'll no longer have to worry about MRDs, and distributions are not taxable.[4] Before deciding, compare the tax rate on converted IRA assets (your current rate) with the tax rate your heirs will pay on inherited assets. If your heirs will be in a much lower tax bracket than your own, then it may not make sense to convert. Of course, this is an important decision, so check with your financial, estate, or tax adviser.

Because a Roth IRA has no MRDs during the lifetime of the original owner, you can leave the assets in place for as long as you live, with the potential to generate tax-free growth. Your heirs will have to withdraw an MRD each year after they inherit the account, but they generally won't be taxed on those distributions, which potentially increases the value of your bequest.

If you are age 70½ or older, you will have to take an MRD first before you convert the remaining assets in your traditional IRA to a Roth IRA (although you can use the MRD to help pay the tax cost of converting the remaining assets). Note: While Roth IRAs are generally not subject to income tax, they are still subject to estate tax, so it is important to plan accordingly.

If you do convert an IRA, you'll have to compute the income tax on the portion of the account assets converted. However, this tax cost may be reduced in proportion to the extent you have made any nondeductible contributions to any IRA, even if it's not the one being converted.

Of course, there are other ways to transfer money to heirs, such as trusts and gifting, so consult a tax adviser before making any decisions.

4.	Do you want to make charitable donations now?

If so, a strategy involving a Roth IRA conversion and simultaneous charitable contributions may advance your philanthropic goals while eliminating the need for MRDs during your lifetime, and managing the tax consequences of a conversion.

The strategy involves performing a Roth IRA conversion, then making a charitable contribution in the same amount as the conversion. In general, the goal is for your donation to help reduce your taxable income by the same amount that the conversion increases it, leaving you with little or no tax impact. You could also make the charitable contribution to a charity that has a donor-advised fund program, and recommend grants to other charities from your donor-advised fund over time.

For example, say you plan to convert a traditional IRA to a Roth IRA, and $100,000 of the assets in the account will be taxed. Making a $100,000 deductible charitable donation from a taxable account would generally offset the converted assets, leaving you with little or no additional tax liability.

The upshot? Your account would be converted to a Roth IRA—eliminating MRDs during your lifetime and providing tax-free potential growth[5]—at little or no out-of-pocket cost, and you'd advance your philanthropic objectives.

"This move is driven by the desire to convert to a Roth IRA," cautions Hevert. "If you don't have a need for a conversion, you may be better off not converting and simply making a charitable donation."

Generally, anyone who has large charitable intentions may not want to convert to a Roth IRA. Typically, the most tax-efficient account to leave to charity at death is a traditional IRA, because the charity does not pay income tax, and the charitable bequest is deductible against an investor's taxable estate. Tax planning can be complex, so consult a tax adviser before taking any action.

There are IRS limits to deductible charitable donations, however. The amount you can deduct for charitable contributions cannot be more than 50% of your adjusted gross income. Your deduction may be further limited to 30% or 20% of your adjusted gross income, depending on the type of property you give and the type of organization you give it to. A higher limit applies to certain qualified conservation contributions.

Have a plan

Whichever scenario applies to you, MRDs are likely to play an important role in your finances in retirement. Building a thoughtful retirement income plan can help you use MRDs in the most effective way, and help you reach your important financial goals. At the very least, it's important to spend some time understanding MRDs and your options with a tax professional, to ensure that you are meeting the IRS requirements—and to help avoid a costly tax mistake.

Before investing, consider the investment objectives, risks, charges, and expenses of the fund or annuity and its investment options. Contact Fidelity for a prospectus or, if available, a summary prospectus containing this information. Read it carefully.

1. Guarantees are subject to the claims-paying ability of the issuing insurance company. In return for a variable lifetime income benefit, the issuing company does assess an insurance charge. 2. Some annuities also include provisions such that, in the event of your premature death, the issuing insurance company provides your spouse or beneficiary with either a lump-sum payment or continued payments over the remaining guarantee period. However, annuities with these provisions generally provide lower payout rates than otherwise similar products without them. 3. Taking a withdrawal may impact the amount of future payments you will receive. Withdrawals of taxable amounts and taxable income received from an annuity are subject to ordinary income tax and, if taken before age 59½, may be subject to a 10% IRS penalty. 4. A distribution from a Roth IRA is tax free and

penalty free provided that the five-year aging requirement has been satisfied and at least one of the following conditions is met: you reach age 59½, become disabled, make a qualified first-time home purchase become disabled, or die. 5. See note 4, above. Investing involves risk, including risk of loss.

ETFs are subject to market fluctuations of their underlying investments and may trade at a discount to NAV.
Municipal money market funds normally seek to earn income and pay dividends that are expected to be exempt from federal income tax. If a fund investor resides in the state of issuance of the bonds held by the fund, interest dividends may also be exempt from state and local income taxes, but may be subject to federal and/or state alternative minimum taxes. Certain funds normally seek to invest only in municipal securities generating income exempt from both federal income taxes and the federal alternative minimum tax; however, outcomes cannot be guaranteed, and the funds may sometimes generate income subject to these taxes. Generally, tax-exempt municipal securities are not appropriate holdings for tax-advantaged accounts such as IRAs and 401(k)s. Fund shareholders may also receive taxable distributions attributable to a fund's sale of municipal bonds.
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The MRD Calculator is intended to serve as an informational tool only, and should not be construed as legal, investment, or tax advice. Please consult a tax adviser or an investment professional about your unique circumstances. Please verify carefully the information that you enter. The results from the MRD Calculator are based on the information you provide throughout the tool, and are only as valid as the information provided by you. Therefore, Fidelity Investments cannot guarantee the accuracy of the results.

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