# IRAs and the Stimulus
## March 2021

Most people think IRAs are simple, but they're not. They can be quite complex. There are many benefits to having an IRA. There are also several pitfalls. There are penalties for withdrawing money too early, too late, too little, or too much. These are discussed below.

**Too Early**

Generally, you must wait until age 59½ to withdraw money from your IRA. If you withdraw too early, there is a 10% tax penalty. And that's on top of regular income tax on the amount withdrawn. The total of those, including all federal and state taxes, can approach 50%. So, don't do this! There are some exceptions if the money is used to pay: health care expenses, college expenses, first home purchase, birth or adoption expenses, total disability, during active military service, or to set up an annuity based on your life expectancy.

The sweet spot for IRA withdrawals is between ages 59½ and 72. During that time frame, you can withdraw all, some, or none of your IRA without penalties. However, all withdrawals from traditional IRAs are subject to regular income tax.

**Too Late or Too Little: Required Minimum Distributions (RMDs)**

If you are age 72 or older in 2021, you must withdraw a minimum amount from your traditional IRA every year. This is known as a Required Minimum Distribution (RMD). It is critical that you take your RMD each year. Failure to do so will make you subject to a 50% tax penalty. Example: John's RMD amount is $40,000 this year. If he forgets to take it, he will be subject to a $20,000 penalty. And that's on top of regular income tax on the $40,000. If John withdraws only $35,000, he will be subject to the 50% penalty on $5,000.

An RMD is based on your life expectancy and the value of your IRA as of the end of the prior year. The IRS' life expectancy tables haven't been updated in several years. However, effective in 2022, those tables will be updated with longer life expectancies. So, starting that year, the RMD amounts will go down a little. However, we'll also be another year older then! Example: A 72-year-old IRA owner who applied the Uniform Lifetime Table to calculate required minimum distributions would use a life expectancy of 25.6 years. Under the 2022 tables, his life expectancy would be 27.4 years. As we age, our life expectancies decrease and our RMDs generally increase.

To determine your RMD, you use the fair market value of your IRA as of the end of last year. You then divide that amount by your life expectancy years.

**"RMD" Withdrawals in 2020**

After the pandemic began, Congress passed the CARES Act and it waived the need to take RMDs for 2020. However, some people had already withdrawn their "RMD" for 2020. The CARES Act allowed persons in this situation to return the RMD to their IRA as a tax-free rollover. However, if you did this, you will probably still receive a 1099-R from your IRA trustee for the original amount withdrawn. You should show that amount on your income tax return on line 4a. You should show $0 on line 4b with the word "rollover" printed to the left of the $0. That way the IRS will know what happened. Tax preparers and tax software should be able to assist you with this reporting.

**IRA Rollovers and the RMD Trap**

When you are over age 72 and subject to taking annual RMDs, there is a trap to avoid. This is because under IRS rules, the first money distributed each year from a traditional IRA is necessarily RMD money. And RMD money is <u>not</u> eligible for a rollover. Example: it's January and you want to move some or all of your IRA to a different IRA trustee. You do the "IRA rollover." If you do so, before you have taken all of your RMDs for the current year, you have been trapped. The amount of your RMD is ineligible for a rollover. That amount will be taxable. Further, you must withdraw the RMD amount from the IRA. In addition to regular income tax, you can be subject to penalties for keeping the ineligible amount in your IRA. So, please remember to withdraw your RMD first, before making any other withdrawals, including rollovers, from your traditional IRA.

Please be aware that you may only make one rollover every 12 months. A second rollover would be invalid and the amount will be taxable income. Again penalties may apply. It is better to move IRA money using a trustee to trustee direct transfer. Those transfers are not subject to the 12-month rule and they avoid the RMD trap.

**Qualified Charitable Distributions (QCDs)**

One of the ways to reduce taxes on your RMDs is to use the QCD strategy. Withdrawals from traditional IRAs are taxable as ordinary income. This includes RMDs, except for QCDs. A QCD is a withdrawal from a traditional IRA after age 72 with the proceeds going directly to a charity. There is a limit on QCDs of $100,000 per year. Most of us won't give that much, but even small amounts work. Again, the amount of your QCD is <u>not</u> taxable. However, it will help satisfy your RMD. Example: John's RMD amount this year is $40,000. He first makes a QCD of $5000 to his favorite charity. That amount is <u>not</u> taxable, but it will satisfy $5000 of John's RMD for this year. The remainder of his RMD ($35,000) will be taxable. To qualify, the QCD must be done by direct transfer from your IRA to the charity. Your IRA trustee can advise you about the procedures to do this.

**Too Much**

Although there is no specific penalty for taking too much from your IRA, there are significant issues to be considered. First of all, traditional IRA withdrawals are subject to income tax at ordinary tax rates. Withdrawals are <u>not</u> eligible for the advantageous capital gains tax rates. Withdrawals add to your other types of taxable income. A large withdrawal will result in your moving up to a higher tax bracket on your total income.  Large withdrawals can also trigger you being subject to higher Medicare Part B premiums, taxation of your Social Security benefits, a surcharge on capital gains (net investment income tax), and a phase-out of your Itemized Deductions.  So, you need to consider the total effects of a large withdrawal.

**Roth IRA Conversions**

You should consider whether a partial Roth Conversion is advantageous for you.  A Roth Conversion involves moving funds from your traditional IRA to a tax-free Roth IRA.  There usually is some immediate income tax to pay for the conversion, but there can be tremendous long term tax advantages.  Amounts converted are treated as taxable income in the year of conversion.  After the conversion, future withdrawals and investment gains will be tax-free for your lifetime, and generally for your spouse's lifetime.  Children and other beneficiaries can also receive the tax-free treatment for up to ten years after your death.  Roth IRAs are a great long term family investment planning tool.  A bonus: there are no RMDs for a Roth IRA while you are living.

You have to be careful not to convert too much in one taxable year.  Remember the "Too Much" discussion above.  However, smaller conversions can be quite tax efficient.  Also, with the current administration calling for tax increases, having a tax-free Roth IRA can help protect you from those tax increases due to the Roth IRA's tax-free nature.  You should carefully review the Roth conversion strategy and discuss it with your financial advisor.

**Stimulus Checks (Heads you win, tails you don't lose)**

The CARES Act created the COVID stimulus checks of up to $1,200 per taxpayer and $500 per qualified child in 2020.  Many received a second round of payments of $600 per taxpayer.  The payments were made based on your 2018 or 2019 tax return (depending when the latter was filed).  However, your true entitlement is actually a tax credit based on your 2020 income tax return.  If the stimulus check you received was less than the amount calculated on your 2020 tax return, you will get an additional payment.  This will be in the form of an additional tax refund or a reduction in your 2020 tax due on your tax return.  If the stimulus check you received was more than the amount calculated on your 2020 tax return, you don't have to pay the excess!  And more good news, the stimulus payments are tax-free.  The recently passed American Rescue Plan payments will be based on the 2019 income tax return unless you have already filed your 2020 return.  However, your actual entitlement will be based on your Adjusted Gross Income as shown on your 2021 income tax return.

***Note:*** *The above information is provided for educational purposes only.  It is not individual tax or financial advice.   It is intended to raise awareness of certain financial issues that may be important to the reader.  Each person has different financial circumstances and goals; therefore, the applicability of the issues discussed varies from one individual to another. You should consult with a qualified financial advisor before doing any transactions.*

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