CPA Practice Advisor

Big Penalties

Should retirees take money out of their qualified retirement plans like 401(k)s and IRAs to help pay for their living expenses? Most retirement-savers in their 70s or older have little choice: Under the federal tax law, they are mandated to make ...

Ken Berry, JD • Oct. 26, 2014

[This is part of a series of articles designed to maximize tax benefits and minimize tax pitfalls at the end of the year.]

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Let's start with some background information. Distributions from qualified retirement plans and IRAs are generally taxed as ordinary income at rates reaching up to 39.6%. If you withdraw funds prior to age 59 ½, a 10% penalty tax also applies on top of the regular income tax. Furthermore, although payouts from qualified plans and IRAs don't count as "net investment income" (NII) for purposes of the 3.8% surtax, such distributions increase your modified adjusted gross income (MAGI) under the surtax calculation.

To compound these tax miseries, you must begin taking lifetime RMDs from qualified plans and traditional IRAs – but not Roth IRAs – no later than April 1 of the year following the year you turned age 70½ and continue to do so each succeeding year. For instance, if a client turned age 70½ in 2014, he or she must take an RMD for the 2014 tax year by April 1, 2015 and then another RMD for the 2015 tax year by December 31, 2015.

However, a client may be able to postpone the inevitable in some cases. If you're still working full-time for an employer where you have a qualified plan and you're not the business' owner, you can delay RMDs until your retirement. This exception only applies to employer-sponsored plans; not to IRAs.

Generally, the amount of the RMD is based on IRS-approved life expectancy tables and the value of the account on the last day of the previous tax year. So distributions for 2014 depend on account balances as of December 31, 2013, even though you're taking out the funds almost one year later.

Note that you don't have to take RMDs from any one account. You can divide up the distributions anyway you see fit as long as the total equals or exceeds the required amount. This gives clients some measure of flexibility at the end of the year.

What’s the penalty for failing to take an RMD? It’s equal to 50% of the amount that

It may take awhile to go through the process, especially if you’re using snail mail to handle the paperwork, so don’t procrastinate. Get the word out to clients well in advance of the December 31 deadline to avoid any unnecessary complications.

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