RMDS AND ROLLOVERS – A DANGEROUS BLEND

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It is early 2021 and two ingredients mix again: retirement money in motion, and required minimum distributions (RMDs). This may not appear to be a dangerous concoction, but when improperly combined, the results can be a bitter beverage.

Required minimum distributions cannot be rolled over, period. Yes, last year was different in that RMDs were waived and account owners subject to RMDs could return those unwanted payments. However, technically what was being returned was a normal distribution. The RMD label on the distribution was magically erased by the CARES Act. Returning an unwanted RMD to an IRA or plan was essentially just a rollover.

Now that RMDs are back in effect, if they are paid out, they must stay paid out. There is no going back. With that said, it is imperative to understand the "first dollars out" rule. When a retirement account owner is subject to RMDs, the first dollars withdrawn from the account are deemed to be the RMD.

Example: Bob has an IRA with a $10,000 RMD for 2021. Bob's account is set to automatically send him his entire RMD in December. Bob takes a distribution of $2,000 in March to cover the costs of building a home tiki bar. These are the first dollars out of Bob's IRA. As such, Bob has just taken $2,000 of his 2021 RMD. Since the $2,000 is RMD dollars, Bob cannot roll those dollars over to a new IRA or return them to his existing IRA.

Where retirement account owners often spill their drink is when they try to move all or a portion of an IRA or work plan prior to taking their RMD. How the money moves matters. If an IRA owner does a direct transfer (whereby the IRA is sent directly from one custodian to another), the RMD can travel along with the transfer. However, if the same person originally chose to move the IRA to the new custodian via a 60-rollover, the RMD amount cannot be included in the amount that is rolled over. It must be retained by the account owner.

The requirement to take the RMD prior to the rollover also rears its head when plan participants - like those in a 401(k) – attempt to move their old work plan to an IRA. A plan RMD cannot be rolled to the IRA. The idea of rolling over a plan balance and then taking the plan RMD from the IRA after the rollover is flawed. The plan RMD is not allowed to enter the IRA, and the first dollars out rule applies. Hopefully, the plan custodian will recognize the situation upon receiving the rollover request and will issue two checks – one for the RMD and one for the remaining balance to be rolled over.

If an RMD is erroneously rolled over, it is not the end of the world. The RMD amount is deemed an excess contribution and must be removed under the excess contribution rules. Prior to October 15 of the year after the year of the excess contribution, the excess plus “net income attributable” must be withdrawn. The earnings will be taxable. If you miss the October 15 deadline, the excess must still be removed, but there will be an additional 6% penalty applied to that excess.

Understanding the rules makes for a sweet elixir. Enjoy your RMD/rollover cocktail!