CAUGHT IN A TRAP: RMDS FROM 401(K) PLANS IN THE YEAR OF RETIREMENT

Monday, August 29, 2022

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Here's a common question: An employee retires in or after the year he turns 72 and wants to roll over his 401(k) funds to an IRA. Does an RMD have to be taken before the funds are rolled over?

What makes this tricky is that required minimum distributions (RMDs) normally don't need to start until April 1 following the age 72 year (or April 1 following the year of retirement for someone using the "still-working exception"). That April 1 is considered the employee's required beginning date (RBD).

If the 401(k)-to-IRA rollover takes place before the RBD, it would make sense that no RMD should be required before the rollover occurs. But, as is the case with many IRA and workplace plan rules, what makes sense isn't always the correct answer. The correct answer is that a RMD from the 401(k) must be taken first, and only what's left can be rolled over.

How can that be? Well, first, the IRS says that the first funds distributed in a year in which an RMD is required are considered part of the RMD (the "first-dollars-out rule"). Second, the first year in which an RMD is required is not the year of the RBD – it's the year of retirement (that is, the year **before** the year of the RBD). Third, RMDs can never be rolled over. Putting all three rules together means that the first dollars received in the year of retirement on or after age 72 are part of the RMD and aren't eligible for rollover.

If the RMD is rolled over, it is considered an excess contribution. To avoid penalty, excess contributions – along with earnings or losses attributable to the excess amount – must be returned by October 15 of the year following the year the contribution was made.

Example: Kaitlin works for Fourth Fifth National Bank and participates in its 401(k) plan. Kaitlin uses the still-working exception to delay plan RMDs beyond age 72. In 2022 at age 73, Kaitlin retires and elects to roll over her 401(k) balance of $400,000 to an IRA. She is aware that her RBD is not until April 1, 2023. For that reason, she rolls over the entire $400,000 (including her 2022 401(k) RMD, which we assume to be $15,000) to the IRA. Since the $15,000 was not eligible for rollover, it is now an excess contribution in the IRA. Kaitlin can fix the error without penalty by withdrawing $15,000, plus or minus earnings or losses on her IRA attributable to the $15,000, from the IRA by October 16, 2023.

Can Kaitlin avoid taking the 2022 RMD from her 401(k) in 2022? Yes, by delaying her 401(k) distribution/rollover until 2023. But then she would have to take two RMDs – the 2022 RMD and the 2023 RMD – before rolling over the rest of her funds.