Casey Mullooly: Welcome back to the Mullooly Asset Podcast. This is episode 403. I'm your host Casey Mullooly. Tom is with me this week. And we're going to talk about something that's inevitable for almost every investor. And that is taking your required minimum distributions. Saving money in tax deferred accounts like 401ks or IRAs is great because your money goes in pre-tax. It gets you a little tax break today and your money grows over time. But the other side of that is that you are going to have to pay tax on that at some point. And that is when your required minimum distributions hit. So in this week's podcast, me and Tom talk all things RMDs, and without further ado here is episode 403. This is an answer from one of our favorite writers here Christine Benz, who works at Morningstar. This article is on ThinkAdvisor. So we'll be sure to link this up and go over and check out the article. But it was an interesting question that Christine answered in the article and that was will taking RMDs drain my account?

Tom Mullooly: So, we look for things to talk about all the time on these podcasts and videos and every now and then we'll get asked a question like this, like, Hey, if I have to take out 5% or 6% of my retirement account as a required minimum distribution RMD, like isn't like, aren't I hurting myself eventually by doing that? And sometimes you think, well, we're not going to talk about that on a podcast or a video because that's so basic, but you know what? It's not.

Casey Mullooly: Yeah.

Tom Mullooly: We get that question asked of us a lot. And Christine Benz from Morningstar for goodness sakes. She gets asked that question a lot.

Casey Mullooly: Yeah. So people are wondering it. So let's talk about it.

Tom Mullooly: Yeah.

Casey Mullooly: So RMDs, RMDs are required minimum distributions, which need to be taken from tax deferred accounts like,

Tom Mullooly: 401k.

Casey Mullooly: 401k, IRA, anything where your money is going in pre-tax. Basically the idea is reach a certain age, that age is 72 right now. You reach that age and then you have to start taking the money eventually because you have to pay tax on it eventually.

Tom Mullooly: It's never been taxed.

Casey Mullooly: Yeah. Right.

Tom Mullooly: So yeah.

Casey Mullooly: Basically the government can't wait anymore and wants to get their cut. But the main idea of the article was that you are required to take that money. So it has to come out of, let's say an IRA, but you aren't required to spend that money.

Tom Mullooly: Right. And so this is, I think, where people just get a little confused with the numbers and we talk all the time about the 4% rule about drawing out 4% of your balance as your money to plan to take out this year. And we like to drive that number even lower. Like we like to see a number that's 3% or even less.

Casey Mullooly: Yeah.

Tom Mullooly: That means you're in good shape, prepared for retirement. And so people see these distribution rates 5%, 6% a year, and they start to get a little worried like, Hey, whoa, whoa, whoa, whoa. Like we built this plan saying we were going to take out say 3% a year. But my RMD, my required minimum distribution is say five and a half percent like Tom, what's going on?

Casey Mullooly: Let's just take a step back further and talk about how are the RMDs even calculated.

Tom Mullooly: Yeah. That's honestly, that's math that people need to know, not necessarily to do the math, but understand how the math works. And so your,

Casey Mullooly: It's not random. I promise.

Tom Mullooly: It's not. So your required minimum distribution in 2022 is based on the value of your retirement account at the end of last year. So whatever the balance was on December 31st, 2021 will determine how much needs to come out in year 2022. And the factor that they use is based on a uniform life expectancy table.

Casey Mullooly: Right. So let's say it's the first year that someone has to take out their RMD. When do they have to do it by and should they take it out all at once? Where does it go?

Tom Mullooly: Sure.

Casey Mullooly: Kind of walk us through that.

Tom Mullooly: So when you are taking your very first required minimum distribution, only in the very first year, you can take it up until April 1st of the year after you turn 72. So understand that if you do that and say, Hey, I turned 72 this year, I'm going to wait as long as possible. I'm going to wait until March 31st of next year to take my first distribution. That means next year you are taking two distributions.

Casey Mullooly: Right.

Tom Mullooly: And then it's once a year after that. So look easy way. When you turn 72, you got to start taking money out.

Casey Mullooly: Yeah. So you're taking your RMD when you turn 72.

Tom Mullooly: Right.

Casey Mullooly: Keep things simple.

Tom Mullooly: Right.

Casey Mullooly: What's the number that,

Tom Mullooly: So the next step is you go to the table that's provided and is provided by the IRS. And it shows life expectancy table for someone at 72. Your first year's number is going to be a factor of just a smidge over 27. So they're estimating, you're going to live to somewhere between 99 and 100 years. And so you take your balance, say it's a million dollars. You divide it by 27.6 in the first year and your number is going to be,

Casey Mullooly: Just over 36,000.

Tom Mullooly: So on a million dollars, you have to take out on your first year 36,000 plus. Okay. About 3.6%. That number, the life expectancy gets lower every year. The percentage that you're taking out because of that gets higher every year. But remember, it's always a sliding scale. It's going to be based on what the number was last year. Okay. So in 2022, we've got kind of an unusual situation. The market's down, but at the end of last year, the market was still doing pretty well. And so people this year have to take out what looks like a fair amount of money next year. If the market does not recover next year, they're going to have much lower required minimum distributions.

Casey Mullooly: Right.

Tom Mullooly: So it's important to understand that there is some math behind it. We're not expecting you to know this math. That's what we do, but just know how it works.

Casey Mullooly: Right.

Tom Mullooly: Every year, your life expectancy number, your factor is going to be different. And every year it's based on the balance of the year ending before, the prior year.

Casey Mullooly: Right.

Tom Mullooly: So the number's going to change.

Casey Mullooly: It's going to change depending on what the market's doing like you said, it's not a set. Your first year balance isn't your balance forever. It recalculates every single year. So the balance is going to change,

Tom Mullooly: Right.

Casey Mullooly: Which I think is an important point for people to know. But getting back to the article, I think that this fear that taking your RMD is going to run your account down and it's going to run your balance down. I think that is the fear that has driven people that ask this question of Christine Benz and ask it of us as well. So we often talk about how you should keep as much money in your investment accounts growing for you as long as possible, because things like inflation eat away at your purchasing power and the RMDs do kind of run counter to that. But like we said, a couple of minutes ago, just because you have to take the RMD doesn't mean that you have to spend it. In fact, what you can do is reinvest the money. You can take it from your tax deferred account and channel it over to a taxable brokerage account.

Tom Mullooly: Casey, this is such a basic point that I think people miss. Every single dollar that comes out of your retirement account, 401k, IRA, whatever, every single dollar that comes out of that account is taxable income to you. If you take your say your required minimum distribution this year is $36,000. You plunk it into a brokerage account and next year it grows by 10%, you have $3,600 and you take the money out, you sell whatever investments are, you're going to pay tax on the $3,600 of gain. You're not paying tax on the whole thing again. People just miss that.

Casey Mullooly: Right.

Tom Mullooly: And it could very well be if it's depending on your income bracket, you may be in a lower tax bracket on that. I mean, it's very possible that you could be in a 0% tax bracket,

Casey Mullooly: Right.

Tom Mullooly: For capital gains, depending on your income tax level.

Casey Mullooly: Right.

Tom Mullooly: So.

Casey Mullooly: So there are ways to take the RMD but still have your money growing for you, which I think is, like I said, it's the main fear that people have about taking their RMDs. I think first is the paying tax on it, which is inevitability. But then second hand is, okay, this money's not growing for me anymore. But like we talked about, there are ways around that.

Tom Mullooly: Yeah. So Christine also talked about, depending on your situation, if you are say retired from a previous job, but you haven't stopped working. If you have earned income, you could actually take this money and put it into a Roth IRA.

Casey Mullooly: Right.

Tom Mullooly: There are income thresholds that you have to be aware of, but it is something that's out there. And technically, if you qualify for a Roth IRA, you may actually qualify for an IRA.

Casey Mullooly: Yeah.

Tom Mullooly: Where you could put money in, but then you're putting money in and taking it out in the same year.

Casey Mullooly: Right.

Tom Mullooly: Kind of defeats the purpose.

Casey Mullooly: Yeah. But I think main idea here is that you can take your RMD, reinvest it, and then still have your money growing for you. Just because you're required to take the RMD doesn't mean that you have to spend it.

Tom Mullooly: So I also want to just add that when we talk about, you have to take a certain percentage every year, based on your life expectancy every year. I think sometimes people get fixed in their head, I have to take out 5% every year. Well, in 20 years, that 20 times five, that's 100%. I'm going to have to take the whole thing out and I'm going to be 85 or 90 or I'm going to drain this whole thing, but it's 5% of what's remaining.

Tom Mullooly: So start with a pizza pie. Okay. And take the first 5% out. Next year, you have to take out 5.4% of what's left.

Casey Mullooly: Right.

Tom Mullooly: The next year you take out 5.6% of what's left.

Casey Mullooly: Right.

Tom Mullooly: So if you follow the math that way, you are never, almost never going to run out of money.

Casey Mullooly: Right. Because it's also think about the first year you take out 5%, you have 95% left.

Tom Mullooly: Right.

Casey Mullooly: And that is not a stagnant 95%. Like we talked about.

Tom Mullooly: Correct.

Casey Mullooly: You could make money in the investments and then be back at what the 100% level was,

Casey Mullooly: Previously.

Tom Mullooly: Yeah.

Casey Mullooly: So then did you even take it out?

Tom Mullooly: Right.

Casey Mullooly: You're back to where you started. So.

Tom Mullooly: Yeah. It's very interesting with these required minimum distributions. Social security uses a single life expectancy, but the lifetime tables for calculating your require minimum distribution are based on a joint life expectancy. And it's not a hard and fast rule, but it's just a coincidence. And Christine kind of tripped into this as well that for a 72 year old, just starting their RMDs, the distribution period is 27 years. That's 99. An 80 year old, starting at their distribution period is just a shade over 20 years. That's 100. And so it's not a hard and fast rule, but basically they're calculating like, okay, you're 80, you've got 20 more years. You're 72, you've got 27 more years.

Casey Mullooly: Right.

Tom Mullooly: And,

Casey Mullooly: I also know that I did a video a couple weeks ago about some potential changes coming to these rules.

Tom Mullooly: Right.

Casey Mullooly: I know the age 72 thing is a new rule. Was that the CARES Act?

Tom Mullooly: So that was the SECURE Act,

Casey Mullooly: Okay.

Tom Mullooly: In 2018, became effective in 2019. They actually raised the age from 70 and a half when you start your required minimum distributions to 72.

Casey Mullooly: Right.

Tom Mullooly: The problem with that is that if you had already begun taking your distributions from the account, you couldn't pause them and start again at 72. Once you started you had to keep going.

Casey Mullooly: Right. And now the video that I did was talking about a new bill that's being discussed in Washington. There's two different versions between the House and the Senate, but I believe it was the Senate bill would raise the age for RMDs to 75.

Tom Mullooly: I don't know if that's such a great idea. I mean, it seems popular. And so if it's popular, it's going to win votes for whatever politician is voting for it. But your kind of by deferring, deferring, deferring, deferring, you may be creating unnecessary taxes down the road for somebody else that you have listed as a beneficiary. There's a fair percentage of the population are like eh, so what. They're getting free money.

Casey Mullooly: Not my problem.

Tom Mullooly: Right. Yeah. Not my problem. And it's found money for them. I get it.

Casey Mullooly: Yeah.

Tom Mullooly: But if this goes to the next generation let's say, or you skip a generation and you go to the grandchildren, now with these beneficiary rules, they have 10 years to drain these accounts. You may be triggering some large taxable income situations for people who are just about ready to apply for college, or apply for a mortgage, or maybe they're in their peak earning years and they're in the highest tax bracket possible. Now we're just layering more money on top. Again, not your problem, but you may be creating more problems for the next generation. Just putting it out there.

Casey Mullooly: Yeah. Something to consider for sure. And like I said, nothing is final right now. The age is 72 as of today in 2022, that's the number that you have to work with and we'll keep you abreast of any changes if they do come through. I think that's going to wrap it up for episode 403 of the podcast. It's good to know this stuff on your own, just to understand how things work and what you can expect if you're approaching that age 72 or just to expect it down the line. So as always, we appreciate you listening and we will be back with you for 404.