

“Maxing Out” The Benefits of Tax-Deferral in Your IRA

It has been said that eventually "all good things come to an end," and that many things are "not as simple as they first appear." Both of these axioms may be true with respect to the tax-deferred nature of traditional IRAs (Individual Retirement Accounts). Whether you are about to retire, or just doing a little retirement daydreaming, the following IRA information may be important to your wallet.

Current tax rules mandate that minimum distribution requirements begin by April 1st of the year after reaching age 70½ (however, employer-sponsored qualified plan distributions can be postponed until retirement if you continue working past age 70½). The minimum required distribution is the balance of the account as of the previous December 31st divided by an appropriate life expectancy "factor." Failure to take required withdrawals results in a 50 percent tax penalty on the shortfall.

"Wring" It Once?

The first required distribution is actually for the year in which you attain age 70½- the IRS merely lets you postpone it until April 1st of the following year. If you did postpone the first distribution (i.e., try to "wring" out a little extra tax-deferral), a second distribution would be due by December 31st for the current year, substantially increasing taxable income for that year.

"Wring" It Twice?

If you elect to calculate minimum distributions based on the joint life expectancy of you and a beneficiary (compared to just your own single life expectancy), your required distributions will be smaller because the calculation assumes that distributions will be spread over a longer period of time. A smaller annual distribution means more money stays in the account, thereby "squeezing" out a little more tax deferral.

Unfortunately, matters are not as simple as they may first appear--in using joint life expectancies; the life expectancy factor for the beneficiary depends on whether the beneficiary is your spouse or someone other than your spouse.

With a spousal beneficiary, the actual age of the spouse is used. However, with a non-spousal beneficiary, a special rule applies. If a non-spousal beneficiary is more than 10 years younger than the IRA owner, the life expectancy factor for the beneficiary assumes that he or she is no more than ten years younger than the owner. This rule effectively limits the potential tax-deferral advantage of trying to spread withdrawals out over a long period of time by naming a much younger beneficiary, such as a grandchild.

In trying to "wring" a little extra tax-deferral out of your IRA, be careful not to squeeze too hard. Implementing minimum distribution requirements may come back to put a tax squeeze on you if you haven't thought through the tax consequences.