Shaping Healthier Retirement Income Planning with IRS RMD Rules

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The 4 percent rule has long provided a conservative strategy for determining an appropriate withdrawal rate from retirement savings accounts, but changing times and increased market volatility have clients wondering—is there a better way? Many of your clients may be following the 4 percent rule because it is simple and makes it very unlikely that the client will run out of money. Unfortunately, it can also be unnecessarily rigid by failing to take investment performance and fluctuations in consumption levels into account—leaving your clients looking for a better alternative. A new study suggests that the IRS required minimum distribution method is likely to outperform the traditional 4 percent method and may provide the solution your clients have been waiting for.

# The RMD Rules

The IRS required minimum distribution (RMD) rules essentially require that your clients begin withdrawing funds from tax-deferred retirement accounts, such as IRAs and 401(k)s, when they reach age 70½. The minimum amounts that must be withdrawn are calculated based on the client’s life expectancy, determined using IRS actuarial data.

The IRS provides tables specifying the percentage of current account assets that must be withdrawn each year based on the life expectancy of the client in any given year after reaching age 70½ (tables are also available for clients beginning withdrawals at younger ages). In the case of a married couple where one spouse is more than ten years younger than the other, the joint life expectancy of the couple is used in the calculation to provide a more realistic estimate of the life expectancy.

The RMD requirements are not meant to provide retirees with guidance on the optimal withdrawal rate, but are meant to ensure that the funds in these tax-deferred accounts are used for retirement income, rather than as estate planning vehicles. Because the requirements seek to ensure that the assets are spent during life, they are a viable alternative to the 4 percent withdrawal rate, even though this was not the original IRS intent in formulating the rules.

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# The RMD Method versus the 4 Percent Rule

As the name suggests, under the 4 percent rule your client withdraws 4 percent of the beginning balance of his retirement savings each year during retirement. While the rule is very simple, it can have unintended consequences. For example, the rigid 4 percent-per-year requirement tends to encourage clients to seek out dividend-heavy investments to supplement their otherwise fixed income, regardless of whether those investments are otherwise appropriate.

Further, the 4 percent rule has clients withdraw 4 percent even in years when their assets may have severely underperformed. The converse is also true, as the rule limits clients to 4 percent withdrawals even if they could afford much more.

A recent study by the Center for Retirement Research at Boston College found that the RMD method may be a better alternative for determining retirement account withdrawal rates than the traditional 4 percent rule. Not only is the RMD approach almost as simple as the 4 percent rule—rather than withdrawing 4 percent each year, the client would consult the IRS tables to determine the applicable percentage—but it offers much more flexibility.

The RMD rule is, in many ways, much more realistic than the 4 percent rule because it bases withdrawals on the current value of the client’s retirement assets. While this requires determining what that value is each year, it also allows clients to modify their consumption levels based on actual account performance. Because the percentages are based on life expectancy and vary with age, it is still unlikely that the client will outlive his assets.

# Conclusion

If your clients are ready for a new retirement withdrawal strategy, the RMD method may provide the solution. Because the strategy is based on the IRS’s own withdrawal requirements, many of your clients may already be familiar with the requirements. Those who are not may be pleased that this approach factors actual market performance into the equation.