3 Mistakes to Avoid Before Taking Required Minimum Distributions

Uncle Sam wants your money.

He has bills to pay, just like you. And he's been waiting patiently for decades for you to hand over his share of your tax-deferred retirement dollars.

He expects some folks to be stubborn about it, so he has an answer. It's called a required minimum distribution (RMD), and savers who have money stashed away in an IRA or qualified retirement account (a 401(k), 403(b), etc.) are expected to take money out and pay taxes annually once they turn 70½ (with some exceptions).

Many people don't realize this. When they get their quarterly 401(k) statements, they think the dollar amount at the bottom is all theirs to spend, however and whenever they wish. But they're wrong - or they've simply forgotten the bargain they struck with the IRS back when they signed up for the account.

If you took your statements into the FBI building in Washington, D.C., and held them under one of those lights that reveals invisible ink, you'd see Uncle Sam's name written right next to your own.

The required withdrawals are based on the balance in your accounts as of Dec. 31 of the year before you turn 70½ and your average life expectancy, according to the IRS. And they increase by a small percentage every year - so the bite can get bigger as you get older. This is something to keep in mind and to discuss with both your financial adviser and tax professional so you can plan appropriately.

Here's the thing: RMDs are, indeed, required. There's a whopping 50% penalty if you miss the deadline - plus, to add insult to injury, you still have to pay ordinary income taxes on the withdrawal. But you can reduce the amount of money you hand over each year with some smart long-term strategizing. Here are three mistakes investors make that a little advance planning can help avoid:

1. Reinvesting RMDs into a taxable account.

   Imagine that you have three buckets where your retirement savings can go. The tax-deferred bucket (IRAs, 401(k)s, etc.) contains primarily pre-tax money you won't pay taxes on until you use it or when you reach 70½. The taxable bucket (non-qualified investment accounts, bank accounts, etc.) holds assets on which you pay taxes on as soon as interest is earned. Year after year, you pay tax, tax, tax. And then there is the tax-free bucket (Roth IRAs, Roth 401(k)s, etc.), which has a beautiful ring to it and is one of the best places to be in retirement.

   You would think every saver taking RMDs would automatically spend those dollars or reinvest them in a tax-free vehicle. But they don't. Many make the mistake of putting the money into taxable investments.

Let's say, hypothetically, that you do this for 10 years in a row: Every year, you take out your RMD and move it to a taxable account. You might not realize how much you're slowly losing. But it can add up to a large percentage of your life savings. For example, 4% of 10 years = 40%.

2. Allowing a tax-deferred account to keep growing.

   Many savers, trained to focus on accumulation, happily watch their tax-deferred dollars increase without considering the consequences. If you do that until your RMDs kick in, though, you're basically growing your IRA for the IRS.

   Let's say you retire at age 60 and you have enough income without touching your tax-deferred money. It might seem crazy to take some of it if you don't need to, knowing you'll have to pay income taxes on it. But those years between 59½ and 70½ offer a golden opportunity to move your money into a tax-free account, a little at a time, to get some control over your tax bracket and your looming tax burden. Many people do not use the lower tax bracket to their advantage.

3. Letting a surviving spouse deal with the RMD.

   Let's say you're a same-age couple whose nest egg continues to grow in retirement - maybe it even doubles. You start taking your RMDs at age 70½ when you're in the 15% tax bracket and your status is married filing jointly.

   Then, a decade later, when the RMD is much higher, one of you dies - the husband. Suddenly, the widow is filing as single, but with the same assets. The RMD easily could throw her into a higher tax bracket - 25% instead of 15%. That's a 67% increase! Caught unprepared in an already tumultuous year, she'll have to come up with that money.

There's an old saying that there are three types of people in this world:

Those who make things happen.

Those who watch things happen.

And those who wonder, "What happened?"

It doesn't have to happen to you, but you must have a plan. And the obligation doesn't go away once you retire - if anything, it gets more complicated.

Be a saver who takes control. Because the bottom line is this: The more money you can keep away from Uncle Sam, the more you'll have for you and your family.