

'In-Kind' RMDs

Quick-Take: In 'down markets' it might make sense to take a required minimum distribution (RMD) in-kind, rather than selling the investments and satisfying the RMD obligation paying cash from the sales proceeds.

Background: We are all familiar with required minimum distributions (RMDs) from a retirement plan, like an IRA. RMDs are not negotiable once the individual turns age 73 unless that individual fits nicely into the 'still working' exception for qualified plans (which has been covered in the past.) The RMD must be taken by the year end, i.e., December 31. The RMD is based on the prior end-of-year retirement account balance. While there is the December 31 deadline by which the owner must take his/her RMD for the year, the government does not specify which investments must be used to satisfy the RMD obligation. Usually, the IRA owner will direct that a portion of his/her IRA be liquidated by the IRA custodian with the liquidation proceeds distributed to the IRA owner, who may then use some of those distribution proceeds to pay the income taxes due on the RMD.

In-Kind RMDs: There may be several reasons to take an in-kind RMD instead of selling stock held in the IRA. The IRA owner might not like the idea of selling an investment when the market is low. An in-kind RMD permits the IRA owner to hold onto the investment. Some investors may like a particular stock that they have purchased in with their IRA, and they think that the stock will perform even better in the future; consequently, they are not enthused about selling that stock just to satisfy their RMD obligation. And for many individuals over the age 73, they may not need any liquid funds resulting from an RMD liquidity event. If that is the case, then taking an in-kind RMD of stock allows the IRA owner to move the stock to a taxable investment account with the potential for more favorable long-term capital gains tax treatment.

Drawback: Even if markets fall, there is still the obligation to take an RMD and pay the income taxes on the RMD. If a separate source of cash is not maintained by the account owner, the owner may end up searching for funds in a 'down market' rather than liquidate a depressed security. An 'in-kind' distribution of stocks from an IRA might make sense, but the income tax liability on the RMD will still exist, which is when other liquid resources will be required (and depleted) to pay the income tax.

No Tax Benefit: An in-kind distribution will not help to reduce the income tax liability associated with the RMD, as that liability is already established based on the IRA's balance at the end of the prior calendar year. Accordingly, there is no RMD-related tax benefit with an in-kind RMD. There may be, though, an investment benefit to an in-kind RMD.

Investment Benefit: If the RMD will not be needed to pay the account owner's living expenses, a transfer of in-kind securities from the IRA to a taxable brokerage account might make sense because: (i) an in-kind distribution of securities can help to maintain the same market exposure, albeit in a different part of the IRA owner's overall investment portfolio; and (ii) an in-kind transfer of securities in satisfaction of the IRA owner's RMD obligation might also reduce the taxes due on any future appreciation when those in-kind securities are ultimately sold (outside of the IRA) at capital gains rates. The trade-off is, as previously noted, that there must be another source of cash, i.e., non-IRA assets, available to pay the income tax due on the in-kind RMD.

Key Point: The benefits of an in-kind distribution are that (i) the IRA owner can maintain exposure to the security investment that has declined in value, with the hope that its value will recover from the 'down market;' and (ii) if the security investment recovers its value, the owner can benefit from lower capital gain rates on future appreciation of that security, or a 'step-up' in basis if the security investment is held until the owner's death.

Example: Beth is a 75-year old who is in the 32% marginal federal income tax bracket. Beth takes an in-kind RMD of stock worth \$50,000 from her IRA to fulfill her RMD obligation. Beth will owe \$16,000 in taxes on the RMD, using other assets to pay the income taxes. If Beth's stock appreciates to \$80,000 during the next three years, and she decides to then sell the stock, her tax bill will be \$4,500 [$\$30,000 \text{ appreciation} \times 15\% \text{ capital gain rate} = \$4,500$]. If Beth had held onto the depressed stock within her IRA and she takes a distribution of \$50,000 cash from a money market fund instead. Beth's tax liability of her RMD will be the same- \$16,000. However, if Beth were to eventually sell the once-depressed stock from her IRA three years later at a market value of \$80,000, her income tax bill on that distribution will be \$25,600.

In-Kind Process: The IRA owner will have to identify the specific securities in his/her IRA that he/she wants to move from their IRA to their taxable stock portfolio. They will then have

to work with the IRA custodian to fill out the necessary forms for an in-kind transfer. The fair market value of the transferred securities will be taxed as ordinary income. As noted, the source of the funds to pay this tax will be other financial resources, as the IRA owner did not receive any cash associated with the RMD. The fair market value of the in-kind securities on the date of distribution becomes the securities' new cost basis in the owner's taxable account for future capital gains reporting. One important caveat to any in-kind RMD is that market fluctuations can distort the process. It takes time to move assets, so if share prices drop during the in-kind stock transfer, the IRA owner may not have fully satisfied his/her RMD obligation for the year. Another consideration is the importance of tracking the value of the in-kind securities with their date of distribution values since those records will establish the 'new' income tax basis in the distributed securities.

Conclusion: Admittedly, few retirees taking RMDs will consider an in-kind distribution of stock from their IRA. However, in 'down markets' it may make sense to take an in-kind RMD and expose future stock appreciation to capital gains tax rates and not the ordinary income tax rates applied to assets held in an IRA.

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