The Growing Importance of Required Minimum Distributions (RMDs)

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According to the Pew Research Center, 3.2 million Americans retired in 2020 (that is 61,000 per week!). This level of retirement is unusual as the average over the past eight years added up to about 2 million Americans per year. As a demographic fact, the baby boomers are changing the shape of retirement that will have important effects on the economy and financial markets.

As the number of retirees increases, there will only be between six and seven years (assuming they retire at age 65) until they will be required to take mandatory taxable distributions from their retirement plans. Two major beneficiaries of these distributions will be federal and state government coffers. The surge in income from RMDs will create an unusual increase in tax revenues as all those dispersals will be taxed as ordinary income even though some, if not most, of those payments occurred because of capital gains. Let’s assume that the average federal taxes paid by each of these 3.2 million Americans equals $5,000 on their RMD. If our calculations are correct, that is about $16 billion in revenues to the federal government This amount will vary for individual states depending on their specific state income tax rates. To the extent that many of these retirees have other sources of retirement income, they may find that the tax on that distribution is at the maximum personal income tax rate. Unfortunately, that rate may be going higher next year.

In addition to federal and state governments, the leisure industry may experience a surge in demand as these retirees begin to spend money on activities that they put off during their working years. This demographic shift should be beneficial for the leisure-time industry for years to come.

From an investment perspective, many clients ask us when they should take their RMD. If an individual needs that distribution to maintain a preferred lifestyle, then a monthly disbursal to supplement other forms of income makes sense. The principle here is like dollar-cost-averaging but this is dollar-cost-averaging out. Using this strategy can lower the volatility in account value compared to taking the whole distribution at once. On the other hand, if the money is not needed for immediate spending, then the retiree might consider taking the distribution at the very end of the year to benefit from the historical returns of the stock market—assuming that some or all the portfolio is invested in stocks.

An aggressive strategy might be to take the RMD at the beginning of the year and invest it in a portfolio of growth stocks, manage the portfolio during the year to sell the losers and hold the winners and end the year with some capital losses to offset the impact of taxes on the RMD. We expect that, for most investors, there will be an advantage to capital gains income over ordinary income. This strategy can be a risky but could, over time, be a way to increase retirement income and lower taxes.