What should I do with my Required Minimum Distributions?

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Based on an article by David F Royer

Many of us have been making contributions to our IRAs and 401(k) plans for many years and have accumulated sizeable nest eggs. While enjoying the comfort of having savings and the tax advantages on our contributions, it's easy to forget that the day will come (age 70 ½) when we will be forced to take fully taxable distributions. Many IRA owners have comfortable incomes and don't need the distributions, and would prefer to not to pay the taxes and pass these accounts to our children and grandchildren. So what should you do?

If you fail to take a Required Minimum Distribution after age 70 ½ you must pay the tax on the failed distribution plus a 50% excise tax. Here is how it works. Let's say your RMD is $10,000 and you fail to take it by December 31st. Here is what will happen. You will have to pay the tax on the $10,000 and a penalty of $5,000 (50% of the failed distribution) on top of the tax. Not a pretty picture. Because you must take the distributions, why not put them to good use. When a distribution is taken and the tax is paid, that money is no longer qualified and you can do anything you want with it.

There are a number of attractive uses for the unwanted distributions and now is a good time to make plans. One example is using the distributions to purchase life insurance. If your goal is to pass that IRA to your children and grandchildren, life insurance may be the perfect solution. Life insurance benefits are income tax free and will have no impact on the beneficiary's income tax bracket. Also life insurance will bypass the time and expense of probate. It can be used to pay for the grandchildren's college education, estate taxes, a new home for your children or anything else the beneficiary chooses. Also your spouse can enjoy the tax free benefits of life insurance to replace your pension benefits allowing you to take higher benefits while you're still living.

Another great use of unneeded RMDs is to purchase Long Term Care Insurance. It is estimated that over 80% of Americans age 65 and over have no form of Long Term Care Coverage and approximately 60% of retired Americans will at some point need some form of assisted living. This can be anything form home health care to nursing home services. Nursing home cost can be as high as $70,000 per year and Medicaid won't kick in until most of your life savings is gone. Using your RMDs to fund this coverage can protect the rest of your savings from going to the nursing home.

Your required distributions from your traditional IRA can also be reinvested into a Roth IRA. The Roth has many advantages over traditional IRAs. Roth IRAs accumulate income tax free and better yet, all future distributions from a Roth IRA are also income tax free for you or your beneficiaries. Fixed annuities are ideal vehicles for Roth IRA contributions. They guarantee the principal and also guarantee a minimum rate of return. Unlike traditional IRAs you can continue to make contributions a Roth even after you reach age 70 ½.

There are many other uses of unneeded IRA distributions. If you're already over 70 ½ you can put those distributions to good use right now. If you're under age 70 ½, it's a good idea to make plans for your distributions today.

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