IRA Age 70 ½ Required Minimum Distributions (RMDs)

Alternatives!

As a former retirement plan manager for Unocal and currently as a Certified Financial Planner, I have often heard retirees complain about the required distributions from IRAs that start at age 70½. Some of these retirees say that they don't need all of the money that they must withdraw for current living expenses. This is especially frustrating since these distributions create federal income taxes for the retiree and, for many, state income taxes also. Most retirees know of no alternative to taking the required distributions. Actually, there are alternatives and that's what this article is about.

Qualified Charitable Distributions (QCDs)
The enactment of the PATH Act of 2015 made permanent the direct transfer of funds from an IRA to a charity without any income taxation. QCDs have been temporarily allowed for several years, but had to be re-authorized by Congress annually. Now QCDs are permanent.

QCDs allow IRA owners who are age 70 ½ or older to directly transfer up to $100,000 annually to a charity. Such transfer can satisfy their RMD requirement and creates no additional income tax. If you are charitably inclined and you don't need the full RMD amount to live on this year, you can use this strategy to accomplish two goals: reduce your income taxes and make a contribution to your favorite charity. Example: if your RMD amount is $50,000 but you only need $40,000 this year for living expenses, you could transfer $10,000 to a charity using a QCD. You would only be taxed on $40,000 while still satisfying your required withdrawal of $50,000 from your IRA.

This is a tax-efficient strategy if you wish to donate to charity.

Qualified Longevity Annuity Contracts (QLACs)
This is a new alternative that has been approved by IRS regulations. This involves moving some or all of your IRA funds into an annuity contract with an insurance company. The transfer is done tax-free. The funds moved into the annuity contract can grow in value until as late as age 85 before RMDs are required. A QLAC involves using a portion or all of your IRA to purchase a deferred annuity. The stream of income from the annuity can commence at any time, but must commence by age 85. While the insurance contract is in non-payment mode, it will grow in value tax-free in accordance with the terms of the contract. Generally, the older you are when you purchase the contract, the greater the monthly payments to you when the annuity payments begin. These annuity contracts can be used as a fixed income alternative to the equities you currently have in your IRA. So, using a portion of your IRA to purchase a QLAC can be a way to diversify your investment portfolio. This author believes in diversification, so I would *not* invest my entire IRA in a QLAC, but only a portion.

Roth IRA Conversion
Unlike a regular or traditional IRA, a Roth IRA has some great advantages. There are no RMDs and distributions are tax-free. The tax-free feature will even continue for your heirs after your death. Like regular IRAs, earnings on investments in the Roth IRA are not taxable; and even better, are not taxed upon withdrawal. It's like having your cake and eating it too.

The problem is how to get money into a Roth IRA. Annual contributions are limited. However, a Roth conversion is not. A Roth conversion involves transferring money or securities from your regular IRA to a Roth IRA. The market value of the funds transferred is taxable in the year of conversion. So there is up-front taxation. However, all future earnings and withdrawals are tax-free. A Roth conversion usually works best if done in gradual amounts over several years. This avoids getting you into higher income tax brackets. This is a strategy that can pay off in the long run for you, your spouse, your children, and other heirs. As mentioned above, your heirs will inherit not only your IRA investments but also the tax-free investing advantage of the Roth IRA. A Roth IRA can literally payoff for generations.

To the extent you move funds from your regular IRA to a Roth IRA; you reduce future RMDs because those funds are no longer in your regular IRA. The amount converted to a Roth cannot be considered as satisfying the current year RMD requirement. It is best to have funds available outside of an IRA with which to pay the additional income taxes incurred in the year of the Roth conversion.

Reasons to do a Roth Conversion:

- You expect income tax rates to increase in the future,
- You expect your taxable income to increase in the future (like higher RMDs),
- Your RMDs exceed your living expenses,
- You will be moving to a state with higher income taxes,
- You are in a low tax bracket this year,
- You have high medical or other itemized deductions this year,
- You have capital losses or business losses this year.

Reasons Not to Do a Conversion:

- You expect income tax rates to decrease in the future,
- You expect to be in a lower income tax bracket in the future,
- You are in a high tax bracket this year,
- You expect your income to go down in the future,
- You will be moving to a state with lower income taxes,
- You do not have money outside of an IRA to pay the income taxes incurred because of the conversion.

Roth conversions have another special feature – the "Do-Over" option. If you make a Roth conversion, you can change your mind and unwind it. This has to be done no later than the extended due date of your tax return for the year of conversion. Example: you do a conversion in January – you can unwind or reverse the conversion until October 15 of the *following* year. Why would you do that? Perhaps you received an unexpected large amount of income after the conversion (e.g. selling stock or real estate, etc.). That, with the Roth conversion puts you into a high tax bracket. Another example: you did the conversion but your investments in the Roth IRA went down in market value – unwind the conversion and not be taxed on an amount that now is worth less.

Tax Withholding

Although it won't reduce your RMD or taxes, you can have a portion or all of your RMD withheld by your IRA custodian for federal and/or state income taxes. This would reduce your quarterly estimated tax payments.

Notice

This article is by Herb Farrington, a CRA member and a Certified Financial Planner. The information provided is intended for educational purposes only, with the intent of informing retirees about financial alternatives that they may not be aware of. Because of space limitations, this is only a quick summary and does not provide complete information about RMDs, QCDs, QLACs, or Roth IRAs. The article is not individual financial advice. The reader should do their own research and consult with their personal financial advisor. The author and the Chevron Retirees Association assume no liability for actions taken by the reader. However, the author is available for questions about this article at herbf76@msn.com

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