ROTH IRA DISTRIBUTIONS: A REVIEW OF THE RULES

By Gary Trock

Taking money out of your Roth IRA for various reasons and at various times can make a difference as to whether or not you become subject to taxes or penalties. To take maximum advantage of a Roth IRA, it is crucial that you understand the basic guidelines.

The Roth IRA is a new, aftertax, non-deductible IRA that features tax-deferred earnings, tax-free distributions, and more liberal contribution and distribution options than the traditional deductible IRA.

These new retirement savings vehicles have attracted considerable interest and media attention. Most of these articles, though, have focused on the advantages of setting up a Roth IRA. Much less attention has been given to withdrawals.

But taking money out of your Roth IRA for various reasons and at various times can make a difference as to whether or not you become subject to taxes or penalties. To take maximum advantage of a Roth IRA, it is crucial that you understand the basic terms and guidelines.

The most important are:

- Qualified distributions;
- Non-qualified distributions;
- The five-tax-year holding period for contributions;
- The 10% early withdrawal penalty on distributions;
- Taxing your distributions;
- The ordering rules for taking distributions out of a Roth IRA; and
- Required minimum distributions.

ROTH IRAs vs. IRAs

Before going over the withdrawal rules, let's go over some Roth IRA basics.

Individuals who meet the eligibility requirements can contribute up to $2,000 a year to a Roth IRA account. However, as with the traditional deductible IRA, there are income limitations for contributions to a Roth IRA.

Unlike a deductible IRA, there is no tax deduction allowed for contributions to a Roth IRA. Instead, income accumulates tax-free in the account, and qualified distributions are not taxed. For non-qualified distributions, the earnings are taxed and may be subject to an additional early withdrawal penalty.

Unlike the traditional IRA, contributions to a Roth IRA can be made even if the individual is beyond age 70½, and distributions are required only upon the death of the Roth IRA owner.

QUALIFIED DISTRIBUTIONS

One of the best ways to take money out of a Roth IRA is to take a "qualified distribution." This is when you are able to withdraw money both tax free and penalty free.

There are four instances in which a distribution (withdrawal) can be considered a qualified distribution.

The first I'll call the "ideal distribution." It is when you have met the five-

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tax-year holding period requirement and you are at least age 59½—if you meet these requirements, you can withdraw money for any reason, at any time, in any amount, and pay no tax and no penalty.

The next three instances I'll call "necessity distributions." These withdrawals also have to meet the five-tax-year holding period and occur when:

- The Roth IRA owner dies or,
- The Roth IRA owner becomes disabled or,
- The Roth IRA owner is a "first-time homebuyer" ($10,000 lifetime maximum).

Becoming Disabled: You are considered disabled if you can furnish proof that you cannot do any substantial gainful activity because of your physical or mental condition. A physician must determine that your condition can be expected to result in death or to be of long-lived and indefinite duration.

Being a "First-Time Homebuyer": To qualify under this first-time homebuyer exception, a distribution must be used to buy, build, or rebuild a first home that is the principal residence of:

- Yourself;
- Your spouse;
- Your child or your spouse's child;
- Your grandchild or your spouse's grandchild;
- Your parent or other ancestor; or
- Your spouse's parent or other ancestor.

A "first-time homebuyer" is anyone who has not owned a principal residence in the last two years. This means that the buyer does not necessarily have to be buying his or her very first home. However, if you use this exception to take a distribution, the distribution must be used within 120 days of receipt of money.

NON-QUALIFIED DISTRIBUTION

In the real world, as we all know, things don't always go as planned. There can be events that require you to take distributions (also referred to as withdrawals) somewhat earlier than anticipated. Withdrawing money from a Roth IRA before age 59½ or before you have had the account for the five-tax-year holding period can lead to taxes or penalties:

- If you withdraw money before age 59½, this will lead to both taxes on earnings and an early withdrawal penalty regardless of whether you have held the account for the five-tax-year holding period (unless you meet one of the exceptions outlined below).
- If the five-tax-year holding period requirement has not been met and the money is withdrawn before age 59½ due to the death or disability of the IRA holder or for first-time homebuying, this will lead to taxes on earnings but no penalty for early withdrawal.
- If you withdraw money before age 59½ for higher education expenses, certain medical expenses, or for medical insurance premiums when unemployed, this will lead to taxes on earnings but no penalty for early withdrawal. This applies whether or not the five-tax-year holding requirement has been met.

Higher Education Expenses: Qualified higher education expenses include tuition, fees, books, supplies, and equipment required for the enrollment or attendance at an eligible educational institution. These expenses can only be for:

- You;
- Your spouse;
- You or your spouse's children; or
- You or your spouse's grandchildren.

Medical Insurance Premiums: These are the medical insurance premiums paid by you in a year in which:

- You lost your job.
- You received unemployment compensation paid under any federal or state law for 12 consecutive weeks.
- You made the withdrawals during either the year you received the unemployment compensation or the following year.
- You made the withdrawals no later than 60 days after you were re-employed.

FIVE-YEAR HOLDING PERIOD

The five-tax-year holding period requirement pertains to both contributions and conversions (qualified rollover contributions). For regular Roth IRA contributions, the holding period begins on the first day of the individual's taxable year for which the first regular contribution is made or, if earlier, the first day of the individual's taxable year in which the first conversion contribution is made to the Roth IRA. The holding period will end on the last day of the fifth consecutive taxable year of the individual.

Keep in mind that you have until April 15 to make a regular Roth IRA contribution for the preceding calendar year, the same due date as your tax return. When doing a conversion contribution, you must complete the conversion within the taxable year you choose.

Since the law refers to "tax year" and not calendar year, this means that it is actually possible to wait less than five full years to meet this condition for regular contributions.

As an example, if you were to make a Roth IRA contribution for the tax year 1999 by the due date of April 15, 2000, you can conceivably meet the condition by taking a withdrawal on January 1, 2004. The five tax years would be 1999, 2000, 2001, 2002, and 2003.

EARLY WITHDRAWAL PENALTY

A 10% early withdrawal penalty will apply to any withdrawal of earnings if you are under age 59½ unless it is a "qualified distribution" or meets certain exceptions. [The exceptions to the penalty on withdrawal of earnings before age 59½ are for reasons of death, disability, "first-time homebuyer," certain medical expenses, certain insurance premiums for the unemployed, or higher education expenses.] It makes no difference that you met the five-tax-year holding period. The IRS just won't accept the idea of letting you get to your earnings before that age, without good cause. Table 2 summarizes the rules.

TAXES ON DISTRIBUTIONS

Once again, if it's a qualified distribution, there is no tax (and no penalty), but if it's a distribution that falls within the five-tax-year holding period, the earnings will be taxed.

If your distribution from a Roth IRA is made after you meet the five-tax-year holding period but before age 59½ and qualifies as one of the following types of distributions, the earnings will be taxed (no penalty though):

- Medical expenses that exceed 7½% of your AGI;
- Medical insurance premiums paid by certain unemployed individuals; or
- Higher education expenses.

THE ORDERING RULES

Now that we are clear about the rules for penalties and taxes, let's take a look at the order in which the IRS looks to taxing and penalizing the distributions from your Roth IRA should penalties and taxes apply.

Below I describe all the possible "elements" contained in a Roth IRA. This will help you understand why you need to keep good records if you will be taking withdrawals before they can become "qualified distributions."

The three basic "elements" of a Roth IRA are:

- Regular Roth IRA contributions (the annual type),
- Qualified rollover contributions (these are the type that you may have converted or rolled over to your Roth IRA), and
- Earnings from any contributions to the account(s).

Since you can have both traditional non-deductible IRA and traditional deductible IRA money in a Roth IRA account due to a conversion, there needs to be a further breakdown of the second item, qualified rollover contributions. This means that you'll need to keep track of the "basis" of all traditional non-deductible IRA funds that exist within your Roth IRA account(s). This is because you can never be taxed or penalized on withdrawals of funds that were from aftertax dollars in the first place.

As a result of the changes from the 1998 act, individuals are no longer required to keep separate accounts for conversion-type Roth IRAs and contributory-type Roth IRAs. If you do have more than one Roth IRA account, you will be treating them as if they were all one when applying the ordering rules on distribution.

Be aware: The 1998 act made it clear that you do not have to keep separate five-year holding periods. This means that the "first" date in which a contribution was made to a Roth IRA account (including qualified rollover contributions) will be the starting date for the five-tax-year holding period.

The order in which the IRS views distributions coming out of a Roth IRA account(s) is:

- Contributions (your regular annual-type Roth IRA contributions).
- Qualified rollover contributions (conversion or rollover funds) on a first-in, first-out basis. The first portion coming out of any of these types of distributions will be the taxable portion.
- Any earnings since the inception of any and all Roth IRA accounts.

One example of applying the ordering rules to a distribution would be as follows: John converted his traditional IRA with a value of $50,000 to a Roth IRA in 1999. It was comprised of $10,000 of non-deductible traditional IRA contributions, $20,000 of traditional deductible contributions, and earnings of $20,000. John also contributed $2,000 to a Roth IRA for 1999. If John, who is under age 59½, had withdrawn $53,000 of his fund (now worth $55,000 including $3,000 in earnings) within the five-tax-year holding period, he would have to pay $4,100 in early withdrawal penalties ($40,000 + $1,000 × 10%) and tax on $1,000. The breakdown is shown in Table 1.

MINIMUM DISTRIBUTIONS

You are not required to take any

TABLE 1. ORDER OF ROTH IRA DISTRIBUTIONS: AN EXAMPLE

Roth IRA Elements in Order of Distribution	Value of Elements ($)	Amount Withdrawn ($)	Amount Subject to Penalty(P) or Tax(T) ($)
Regular Roth IRA Contribution	2,000	–2,000	n/a
Qualified Rollover Contribution:			
Taxable Portion	40,000	–40,000	40,000(P)
Non-Taxable Portion	10,000	–10,000	n/a
Earnings	3,000	–1,000	1,000 (P&T)
Totals	55,000	53,000	41,000

TABLE 2. ROTH IRA DISTRIBUTIONS AFTER MEETING FIVE-TAX-YEAR HOLDING PERIOD BUT UNDER AGE 59½

Purpose of Distribution	Penalty	Tax	Penalty Applies to:	Tax Applies to:
No excludible purpose	✔	✔	earnings	earnings
Death				
Disability				
First-time homebuyer				
Medical expenses over 7½% AGI		✔		earnings
Insurance premiums of unemployed		✔		earnings
Higher education expenses		✔		earnings

TABLE 3. ROTH IRA DISTRIBUTIONS NOT MEETING FIVE-TAX-YEAR HOLDING PERIOD AND UNDER AGE 59½

Purpose of Distribution	Penalty	Tax	Penalty Applies to:	Tax Applies to:
No excludible purpose	✔	✔	earnings & *	earnings
Death		✔		earnings
Disability		✔		earnings
First-time homebuyer		✔		earnings
Medical expenses over 7½% AGI		✔		earnings
Insurance premiums of unemployed		✔		earnings
Higher education expenses		✔		earnings

** Taxable portion of qualified rollover contributions (conversion contributions) that would normally have been included in income if the distribution were actually received and not rolled into a Roth IRA. Essentially, these are amounts that represented the earnings and deductible portions of traditional IRA funds at the time of conversion.*

mandatory distributions with a Roth IRA as long as you are living. This is in contrast to a traditional IRA, which requires that minimum distributions begin after reaching age 70½.

There are, however, required minimum distribution rules that you should be aware of that apply after an IRA owner dies. If you've named someone other than your spouse (a spouse is treated as the Roth IRA owner also) as the beneficiary, he or she will have to take distributions in one of two ways. First, he can take distributions totaling the whole balance of the Roth IRA account by December 31 of the fifth year following your death. Second, he can also take distributions over his life expectancy, beginning in the year following the year of your death. If he chooses the life expectancy rule, distributions need to begin no later than December 31 of the year following your death.

Not having to take distributions from a Roth IRA is one of the biggest advantages for those who will not be needing IRA funds during retirement. You can plan for more advantageous estate planning. By naming a child or grandchild as a beneficiary, you can eliminate a good deal of income tax and therefore leave a larger estate for your heirs.

To illustrate, let's say you're age 60, don't need IRA funds during retirement, and have $100,000 in a Roth IRA returning 8% per year. If you lived to age 85, the value of your Roth IRA would be $684,848. The grandchild (age 35) would then be required to take distributions over his or her life expectancy. Since the grandchild is a non-spousal beneficiary and more than 10 years younger than the owner, he or she would be required to use certain rules (Minimum Distribution Incidental Benefit rules). Even with the rules, the value becomes quite large (well into seven figures) and the distributions significant. This shows you how impressive tax-free compounding can be.

A ROTH SUMMARY

One of the major attractions of the Roth IRA is the ability to withdraw funds tax free. However, certain kinds of withdrawals can be subject to taxes and penalties. Tables 2 and 3 summarize which types of distributions are taxable and which ones are subject to the early withdrawal penalty of 10%.

To take maximum advantage of your Roth IRA, it pays to understand the rules before you start playing the game. ✦