WHAT YOU NEED TO KNOW ABOUT TAKING DISTRIBUTIONS FROM IRAS

By Clark M. Blackman II and Ellen J. Boling

The rules regarding distributions vary based on the type of IRA you have chosen; it is important to understand those differences in order to select the one that is best for you. In addition, the terms of your IRA account may limit distribution options. The tax law is much more flexible than many IRA agreements.

Generally, there are three tax-advantaged IRAs you can use to save for your retirement. Your options are:

- Traditional deductible IRAs,
- Traditional non-deductible IRAs, and
- Roth IRAs.

Each type of IRA has unique rules pertaining to contributions and distributions that you need to understand when trying to determine which IRA, if any, is the best vehicle for *you*.

This column is the second part of a two-part series on IRAs. The first part focused on limitations and taxability of IRA *contributions* (see the April 2000 *AAII Journal*, available on our Web site at www.aaii.com); this article focuses on limitations and taxability of IRA *distributions*.

DEDUCTIBLE IRAs

The principal and earnings in a traditional deductible IRA are not taxed until you withdraw them. However, because a traditional IRA is a tax-favored means of saving for your retirement, there are rules limiting the withdrawal and use of your IRA assets. Violation of the rules typically results in additional taxes in the year of violation.

Generally, withdrawals before age 59½ are subject to a 10% early withdrawal penalty, in addition to the regular income tax payable on the distribution. However, there are a number of exceptions to this rule, which are presented later (see Table 1).

After age 59½ and before age 70½, you can withdraw any amount of assets from your traditional IRA without penalty. However, you are not *required* to withdraw any assets from your IRA until you reach age 70½.

Minimum Distribution Requirement

The primary purpose of a qualified retirement plan is to provide retirement income to you when you retire. To prevent indefinite deferral, all qualified retirement plans are subject to minimum distribution requirements. If you do not take the required amount of withdrawal, you have to pay a 50% excise tax. The penalty is 50% of the difference between the actual amount distributed and the amount that should have been distributed, and it is in addition to the regular tax on the distribution. The IRS can, and typically will, waive this penalty when the failure to distribute is inadvertent and steps are taken to immediately distribute the required amount.

To satisfy the minimum distribution requirements, you must withdraw the entire balance of your traditional IRA or start receiving periodic distributions beginning no later than your required beginning date (RBD). For most individuals the required beginning date is April 1 of the year following the year in which you reach age 70½. (In situations where a company is maintaining the retirement plan, special rules exist for employees who are less than 5% owners of the company, who may defer their required beginning

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TABLE 1. IRA WITHDRAWALS BEFORE AGE 59½: PENALTIES AND CONSEQUENCES

	Tax-Deductible IRA	Non-Deductible IRA	Roth: Less than 5 years	Roth: 5 years or older
Higher Education*				
10% Penalty	No	No	No	No
Income Tax Due	Yes	On earnings, not original contributions	On earnings, not original contributions	On earnings, not original contributions
1st Time Home Purchase**				
10% Penalty	No	No	No	No
Income Tax Due	Yes	On earnings, not original contributions	On earnings, not original contributions	No
Death or Disability				
10% Penalty	No	No	No	No
Income Tax Due	Yes	On earnings, not original contributions	On earnings, not original contributions	No
Any Other Reason				
10% Penalty	Yes, w/exceptions†	On earnings, w/exceptions†	On earnings, w/exceptions†	On earnings, w/exceptions†
Income Tax Due	Yes	On earnings, not original contributions	On earnings, not original contributions	On earnings, not original contributions

**Higher education expenses must be for you or your family members. Expenses include tuition, fees, room and board (if the student is enrolled at least part time), books and supplies.*

***First-time home purchase limit is $10,000. To qualify, you must not have owned a home for the past two years. This exemption can be used to buy, build or rebuild a first home for you, your parents, your children or your grandchildren. Distribution must be used within 120 days of receipt for those costs. If you use only part of you exemption, you can use the remainder another time.*

†Exceptions include: (a) if your medical expenses exceed 7.5% of your adjusted gross income; (b) if you annuitize your withdrawals; (c) if you collect federal unemployment benefits for 12 consecutive weeks and use IRA withdrawals to pay for health insurance.

date until April 1 following the calendar year *in which they retire.*)

If you choose to receive periodic distributions instead of a lump-sum payment, you must do so over one of the following periods:

- Your life,
- The lives of you and your designated beneficiary,
- A period that does not extend beyond your life expectancy, or
- A period that does not extend beyond the joint life and last survivor expectancy of you and your designated beneficiary.

Amount of Minimum Distributions

The amount of the required minimum distributions depends on your age and the age of your designated beneficiary (if any). Your annual distribution is equal to your IRA balance at December 31 of the prior year, divided by the life expectancy factor applicable for the form of periodic distribution selected (the four methods outlined above).

The actual distribution may be made from one, several, or all of your various IRA accounts, but the total amount distributed must equal or *exceed* the calculated minimum required distribution for all plans combined.

NON-DEDUCTIBLE IRAs

Traditional non-deductible IRA distribution rules, including penalties and minimum distribution requirements, are the same as those discussed above for traditional deductible IRAs, with one main exception. Unlike traditional deductible IRAs, a portion of the distribution from traditional non-deductible IRAs is tax-free. The pro-rated amount of the distribution attributable to the non-deductible contribution is not taxed. This is because contributions to non-deductible IRAs are not deducted from taxable income when made, and thus, tax has already been paid on the amounts contributed.

ROTH IRA

The Roth IRA is the newest type of IRA; it is similar to traditional IRAs, with a few key differences.

Like non-deductible IRAs, Roth IRAs are funded solely with aftertax (non-deductible) contributions. However, unlike non-deductible IRAs, income accumulates tax-free in a Roth IRA account, and qualified distributions from the account are not included in taxable income.

Distributions from a Roth IRA are characterized in the following order based upon the value of the account at the end of the year:

- Annual contributions
- Converted contributions
- Earnings

TABLE 2. IRA DISTRIBUTION LIMITATIONS AND TAXABILITY

	Traditional Deductible IRA	Non-Deductible IRA	Roth IRA
General Rules			
Definition	Deductible individual retirement account established by a taxpayer	Non-deductible individual retirement account established by a taxpayer	Non-deductible individual retirement account established by a taxpayer
Distribution Rules	Taxpayer may start taking distributions after age 59½. Taxpayer must start taking distributions after age 70½.	Taxpayer may start taking distributions after age 59½. Taxpayer must start taking distributions after age 70½.	No mandatory distribution rules.
Eligible for Rollover	Can be converted to a Roth IRA if the taxpayer's AGI is less than $100,000. Married filing separate taxpayers may not convert to a Roth IRA.	Can be converted to a Roth IRA if the taxpayer's AGI is less than $100,000. Married filing separate taxpayers may not convert to a Roth IRA.	Roll over to another Roth IRA is permitted.
Taxation			
Accumulation of Income Inside the Plan	Tax-deferred	Tax-deferred	Tax-free
Distributions of Contributions	Taxed at ordinary income rates.	Tax-free	Tax-free
Distributions of Accumulated Income	Taxed at ordinary income rates.	Taxed at ordinary income rates	Qualified distributions (after 5 years and age 59½, death, disability or first homebuyer up to $10,000) are tax-free. Non-qualified distributions of accumulated income are taxed at ordinary rates.

Qualified Distributions

Distributions from a Roth IRA are considered to be non-taxable qualified distributions if they are made at least five years after the first taxable year in which the individual made a contribution to the Roth IRA, and if one of the following applies:

- They are made after the IRA owner reaches age 59½,
- They are made after the IRA owner's death,
- They are on account of the IRA owner's disability, or
- They are used for qualified first-home purchases.

Non-Qualified Distributions

Non-qualified distributions are included in income to the extent of earnings, after recovery of the non-deductible contributions, and are subject to an additional 10% early withdrawal tax. Since a Roth IRA is treated in most cases in the same manner as a traditional IRA, the exceptions that apply to the imposition of the 10% penalty tax on IRA distributions will also apply to Roth IRA distributions (outlined in Table 1).

No Minimum Distribution Requirements

Unlike traditional IRAs, minimum distribution requirements do not apply to Roth IRAs. As a result:

- You do not need to begin distributions by April 1 of the calendar year following the calendar year in which you attain age 70½.
- You can delay indefinitely the date at which distributions will commence.
- Distributions are required only upon death.
- You can arbitrarily determine each year how much, if any, you wish to withdraw.
- A penalty for insufficient distributions can never be imposed on you.
- Your surviving spouse may roll over your Roth IRA into his or her own and delay distribution until his/her death. If a non-spouse is named as the designated beneficiary, that person must distribute the entire account within five years of the owner's death or over the beneficiary's expected lifetime, starting the year of the owner's death.

IRA WITHDRAWALS BEFORE 59½

Generally, if you are under age 59½ and you withdraw money from your IRA, you must pay a 10% additional tax. However, there are a number of exceptions to this rule.

You may receive distributions from your IRA that are part of a series of "substantially equal payments" over your lifetime (your life expectancy), or over the lives (or the joint life expectancy) of you and your beneficiary, without having to pay the 10% additional tax, even if you receive such distributions before you are age 59½. You must use an IRS-approved distribution method (life expectancy method, amortization method or annuity factor method) and you must take at least one distribution annually for this exception to apply. In addition, the payments under this exception must continue for at least five years, or until you reach age 59½, whichever is the longer period. The five-year rule does not apply if a change from an approved substantially equal payment distribution method is made because of the death or disability of the IRA owner.

Table 1 summarizes additional exceptions and consequences that you may face if you withdraw money before age 59½ from your IRA accounts.

Table 2 summarizes IRA distribution limitations and taxability.

CONCLUSION

It is important to understand that the terms of your IRA account may limit distribution options; those terms vary from institution to institution. For example, some IRA agreements do not permit recalculation of life expectancies, and some provide only lump-sum distributions after death. The tax law is much more flexible than many IRA agreements.

Contact your tax or financial planning advisor to assess your situation and determine which vehicle is best for your personal situation. ◆