

## **Navigating the Maze of IRA Distributions**

Confused about IRA distributions? You're not alone. If you ask ten different people about the rules, penalties, and tax consequences of IRA distributions, you're likely to get 11 different answers. The fact is, a wrong move could cost you dearly.

### **The problem**

Distribution rules for individually-owned IRAs differ from those of employer-sponsored plans. Plus, we now have two types of IRAs - "traditional" and Roth. "The treatment of Roth IRAs varies significantly from other IRAs," explain consultants Thomas F. Streiff and David Shapiro in their book, *Distributions from Qualified Plans*. "It is no longer possible to present a one-size-fits-all explanation of IRA distributions." (Thomas F. Streiff and David Shapiro, *Distributions From Qualified Plans* (Chicago: Dearborn, 1998) pg. 26.)

Just as important, distribution rules are governed by your age when distributions begin, as well as how they are taken. Understanding these rules can mean the difference between tax savings and a potential tax liability as high as 50%. To help avoid a costly mistake, please consider the following guidelines when planning your retirement strategy.

### **Getting Your Money Out of a Traditional IRA**

With a traditional IRA, your contributions may be tax deductible, depending upon your income and participation in an employer-sponsored qualified plan. However, distributions, at the time they are taken, may be taxable as income.

Your age is the determining factor. "You can get in trouble if you begin taking distributions earlier than age 59 1/2, or if you don't begin taking enough by the time you turn 70 1/2," Ann Shropshire, CLU, associate publisher with Dearborn Financial Publishing, told New York Life in a 4/14/2000 interview.

If you take money before age 59 1/2, you can be hit with a 10% IRS penalty on any taxable amounts in addition to income taxes at the ordinary rates. (The full amount of your distributions is taxable if you could deduct all contributions at the time they were made; if only a portion of your contributions were deductible, that portion — plus all earnings — is taxable.) Please note that surrender charges may also apply from the issuing company for your IRA funding vehicle.

Fortunately, there are a number of exceptions. Shropshire explained that penalty-free withdrawals can be made from your traditional IRA (though income taxes still apply) prior to age 59 1/2 under the following circumstances:

- By your beneficiaries, at your death.
- If you become disabled.
- If the money is used to pay qualifying medical expenses (when they exceed 7.5% of your adjusted gross income).
- If you are unemployed, to pay the costs of health insurance.
- If the money is withdrawn to pay for "higher education" costs for yourself, your spouse, children, or grandchildren.
- If you use the money (up to \$10,000) for the first-time purchase of a home for yourself.
- If you made an excess contribution, you can take out that amount on or before the due date, including extensions, of your federal income tax return (If you leave it in, you will be subject to a 6% excise tax). However, if you withdraw the net income

attributable to the excess contribution, it will be included in income and subject to the 10% penalty.

- At any age, under what is known as the Substantially Equal Periodic Payment Exception, if payments (at least annually) are spread out equally over your projected life expectancy.
- If you are between 59 1/2 and 70 1/2, you are not penalized for withdrawals or failing to make withdrawals. You can let it sit, take the entire amount in a lump-sum, make systematic withdrawals — all without penalty.

If you are age 70 1/2, you MUST begin taking Required Minimum Distributions by April 1 in the year after you turn 70 1/2. Otherwise, a massive penalty applies. You will be hit with a 50% penalty on the difference between what you should have taken and what you actually took. Example: If you were required to take \$5,000 in a given year based on your Required Minimum Distribution calculation, but only took \$1,000, you will pay a \$2,000 penalty (50% of the undistributed \$4,000).

### **Getting Your Money Out of a Roth IRA**

A Roth IRA has significant differences from its traditional brother:

- Contributions are not deductible. They are made with after-tax dollars.
- Contributions (though not earnings) can be withdrawn at any time without income tax consequences.
- Contributions can be made after age 70 1/2. With traditional plans, contributions are not allowed after this age.
- Qualified distributions are completely income tax-free. Non-qualified withdrawals of earnings are subject to the 10% early withdrawal penalty, plus income tax.

To withdraw earnings without penalty from a Roth IRA, the funds must have remained in the IRA a minimum of five years AND at least one of the following criteria is met:

- You are age 59 1/2 or older.
- You are disabled.
- It is made to your beneficiaries after death.
- You use the money to purchase a first home; up to \$10,000 in your lifetime.

**Note:** With a Roth IRA, there is no Required Minimum Distribution Requirement at age 70 1/2. In fact, you may continue making contributions as long as you are working, and can let your IRA accumulate throughout your lifetime.

### **The bottom line**

We have attempted to provide a brief summary of the many factors that can affect your IRA distribution; however, New York Life does not offer tax advice. We recommend that you consult your tax advisor for more information regarding your specific situation.