

# WITHDRAWING FROM YOUR IRA:

## A GUIDE TO THE BASIC DISTRIBUTION RULES

By Clark M. Blackman II and Ellen J. Boling

Since IRAs are vehicles to encourage saving for retirement, penalty-free regular distributions cannot start until after the account owner turns age 59½. But there are exceptions that allow you to avoid the 10% penalty.

IRAs (individual retirement accounts) are powerful savings vehicles in which to save for retirement in a tax-deferred, and in one case, tax-free environment.

Generally speaking, an IRA is a vehicle similar to an employer's 401(k) in that contributions grow tax deferred. It is important to note that an IRA is not an investment per se, but a means to invest retirement dollars in a tax-advantaged way. Think of the IRA as a pot with certain tax advantages, into which you must put an investment. You still need to make investment decisions based on your own risk tolerance and investment philosophy.

### TYPES OF IRAS

Prior to 1997, there was only one type of IRA. The Taxpayer Relief Act of 1997 created a second type, the "Roth" IRA. From this point forward, the original IRA became known as a "traditional" IRA.

**Traditional IRAs:** A traditional IRA allows for tax-deferred growth of an investment. There is no tax until the funds are actually distributed out of the account. Upon distribution, the taxable portion will be treated as ordinary income. This is true regardless of the type of investment. Distributions of otherwise tax-free income (e.g., interest from a municipal bond) will be fully taxable at ordinary tax rates. Therefore, tax-exempt investments are not recommended for these accounts.

**Deductible and Non-Deductible Contributions:** A contribution to a traditional IRA may be treated as deductible or non-deductible, depending on various factors. A deductible contribution is one that will actually lower your taxable income when contributed, essentially making it a "pretax" contribution. A non-deductible contribution does not lower your taxable income in the year of contribution. However, a portion of each future distribution from the account will be treated as a nontaxable return of principal to you.

We discussed the difference between deductible and non-deductible contributions in our last article ("What You Need to Know About Making Contributions to an IRA," June 2002 *AAII Journal*, available at [AAII.com](http://AAII.com)). For purposes of understanding the distribution rules relating to non-deductible contributions, consider the following example:

Sally makes regular \$3,000 contributions to her IRA each year for 20 years. In two of those years, her "adjusted gross income" (line 33 of tax form 1040) exceeded the amount allowing her to deduct the \$3,000 amount (see the above mentioned article for these limits). Therefore, out of a total of \$60,000 contributed (\$3,000 × 20 years) she has \$6,000 (\$3,000 × 2) that constitutes a "non-deductible" contribution. During retirement, every distribution from her IRA (or IRAs if she has multiple accounts) will be partially tax free as a return of previously taxed income (i.e., the \$6,000 non-deductible contribution). If at the beginning of the year of her first year of retirement,

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*Clark M. Blackman II, CPA/PFS, CFP, is managing director of Post Oak Capital Advisors, in Houston, Texas. Ellen J. Boling, CFP, is director of Private Client Advisors for Deloitte & Touche LLP in Cincinnati, Ohio.*

**TABLE 1. SUBSTANTIALLY EQUAL PERIODIC PAYMENTS:****A COMPARISON OF CALCULATION METHODS**

For a \$500,000 account, 7% interest rate, owner is age 50 and first-year withdrawal is in 2002.

	Minimum Distribution Method	Annuity Factor Method	Amortization Method
First Year Withdrawal Amount	\$12,755	\$38,118	\$37,654

the balance of all her IRAs combined is \$100,000, then 6% (\$6,000 ÷ \$100,000) of her distribution that year would be tax exempt. If she takes \$10,000, then only \$9,400 is taxable. In the second year, the numerator in that same equation would be \$5,400 (\$6,000 – 600), and the denominator is the market value of her combined IRAs as of the beginning of the next year she takes a distribution.

**Roth IRA:** The other type of IRA is the Roth IRA, which allows for tax-free growth over the life of the account. There is no tax deduction in the year of contribution, but the contributions and all earnings in the account are distributed tax free upon withdrawal. Another attractive feature of a Roth is that it escapes the required minimum distribution rules at age 70½ that are discussed below.

With that basic background information regarding the types of IRAs, you can better understand the various distribution rules and tax consequences of the timing of distributions from IRAs.

### EARLY DISTRIBUTIONS

Since IRAs are vehicles to encourage saving for retirement, penalty-free regular distributions cannot start until after the account owner turns age 59½. Generally speaking, a withdrawal prior to age 59½ will be subject to the ordinary income tax and a 10% early distribution penalty.

Certain exceptions that allow you to avoid the 10% penalty will be discussed later. All taxable distribu-

tions from traditional IRAs will be subject to ordinary income tax—i.e., no “capital gains” rates are applicable on distribution.

You might be able to use one of the following exceptions to avoid the 10% penalty:

- Distributions due to death;
- Distributions due to disability;
- Distributions in the form of a series of “substantially equal periodic payments” (discussed below);
- Distributions for qualified deductible medical expenses;
- Distributions for qualified higher education expenses; and
- Distributions for qualified first-time homebuyer distributions, up to a lifetime maximum of \$10,000.

### AVOIDING THE PENALTY

A substantially equal periodic payment plan is the distribution option that allows an account owner who is younger than 59½ to receive distributions from an IRA without the 10% early distribution penalty. The substantially equal periodic payment amount must be withdrawn each year for the greater of five years or until the account owner attains age 59½. For example, someone who begins a substantially equal periodic payment at age 50 would be required to take out the equal amounts each year for 9½ years. Someone who begins a substantially equal periodic payment at age 58 would be required to take out that amount for five full years, or until they attained age 63.

It is also important to note that a

substantially equal periodic payment distribution only avoids the 10% penalty; the distributions will still be subject to ordinary income tax.

The substantially equal periodic payment is a financial calculation best determined by a financial adviser. There are three methods to calculate an allowable withdrawal amount—minimum distribution, annuity and amortization. (The mechanics of these calculations appear in our October 2000 *AII Journal* article, “Early Plan Distributions: How to Avoid the 10% Penalty.”) The minimum distribution method takes into consideration the account owner’s age, account balance, and life expectancy. The annuity and amortization methods also factor in a reasonable interest rate. Typically, a larger withdrawal amount results with the amortization and annuity methods. The dollar amount yielded by the formula is the amount the account owner may withdraw from the account without paying the 10% early distribution penalty.

Table 1 shows the withdrawal amounts for the first year under the three substantially equal periodic payment methods. The amounts assume a \$500,000 account, 7% interest rate, that the account owner is age 50 and that the first withdrawal year is 2002.

Once an account owner starts a substantially equal periodic payment, the amount withdrawn cannot be changed until the greater of five years or when the owner reaches age 59½. The dollar amount that comes out of the IRA must be the same each year (although under the minimum distribution method the amount varies based on the changing year-end account balance and owner’s life expectancy each year).

Let’s say you start a substantially equal periodic payment at age 50, and the penalty-free dollar amount to be withdrawn is \$50,000 (based on either the amortization or annuity methods). In this example, you would be required to withdraw \$50,000 each year until age 59½.

Now, let's assume that at age 55, you have a drastic lifestyle change that requires \$75,000 a year in withdrawals: You cannot get the additional \$25,000 out of the same IRA before age 59½. If the additional monies were withdrawn from that IRA, the account owner would be subject to penalty and interest on the distributions all the way back to the first distribution at age 50—a potentially devastating penalty.

A solution for this potential cash flow crunch is for you to split your original IRA into one or more separate accounts and to take initial, substantially equal periodic payment amounts only from one IRA. This, of course, presumes that you don't need to annuitize the entire account balance to generate your required cash flow. Then, if additional withdrawals are needed, substantially equal periodic payments can be taken from a second IRA, using a different calculation method if you so choose. The second stream of substantially equal periodic payments must also be taken for the longer of five years or until you reach age 59½.

**EMPLOYER PLAN ISSUES**

Individuals often roll over employer plan assets into IRAs. But before you

do so, make sure you understand the differences in distribution rules. You may be eligible for special tax rules that decrease the amount of tax you pay on plan withdrawals, such as if you withdraw employer stock held in the employer retirement account all at once (called a "lump-sum distribution").

A distribution of employer stock requires an up-front tax payment that is calculated using the cost basis of the employer stock as the taxable amount of the distribution. You may also be able to use "averaging" or "capital gain" elections to compute this up-front tax.

If you were born before January 1, 1936, you may elect to use 10-year averaging with or without capital gain treatment. Without capital gain treatment, your entire taxable distribution is taxed as ordinary income based on the 1986 tax rate schedule for a single taxpayer (regardless of your filing status for the year of the distribution). The taxable value is divided by 10, the tax is calculated on that portion of the account, and the resulting tax is multiplied by 10 to determine the actual tax payable. If you also make a capital gain treatment election, a portion of the

taxable value is treated as capital gain income subject to a 20% rate. The portion of the distribution that may be treated as capital gain is determined by multiplying the total taxable distribution by a ratio. The numerator of the ratio is the number of your months of active participation in the employer plan before 1974, and the denominator is your total months of active participation in the plan. The total tax payable on the distribution in this case is the sum of the tax on the capital gain portion and the 10-year averaging tax on the ordinary income portion.

If you are a long-term holder of your employer stock in your plan account, your cost basis may be very low in relation to its fair market value at the time of distribution. When the stock is subsequently sold after distribution, you will pay tax on the difference between the stock's then fair market value and the original cost using capital gain tax rates. This can be more beneficial than the tax effects of distributions from an IRA, which are taxed as ordinary income on the full fair market value of the assets.

The below example shows how utilizing the trustee cost basis rule on employer stock can save taxes in the long run.

Assume that at age 60 Deirdre Daley accepts early retirement from ABC Corporation, a pharmaceutical company, after 25 years of service. Deirdre has \$1,200,000 in her retirement plan. The underlying investments in the retirement plan include several mutual funds and 6,000 shares of ABC common stock. The company stock

**TABLE 2. HOW THE TRUSTEE COST BASIS RULE CAN LOWER YOUR TAX BILL**

	Pay Tax Using Cost Basis Rule	Pay Tax Without Using Cost Basis Rule
Total Value of Plan	\$1,200,000	\$1,200,000
Mutual Funds	\$612,000	\$612,000
ABC Common Stock	\$588,000	\$588,000
Cost Basis of ABC Stock	\$138,000	na
Net Unrealized Appreciation of ABC	\$450,000	na
Taxable Value	\$750,000*	\$1,200,000
Taxes on Mutual Funds @36%	\$220,320	\$220,320
Taxes on Cost Basis of ABC @36%	\$49,680	na
Taxes on Fair Mkt. Value of ABC Stock @36%	na	\$211,680
<b>Total Income Tax @ Distribution</b>	<b>\$270,000</b>	<b>\$432,000</b>
Capital Gain Income on Net Unrealized Appreciation of ABC	\$450,000	\$0
<b>Capital Gains Tax @ 20%</b>	<b>\$90,000</b>	<b>\$0</b>
<b>Total Tax</b>	<b>\$360,000</b>	<b>\$432,000</b>

\* Mutual funds plus cost basis of ABC stock.

appreciated 120% the year after the company received a patent on a significant cancer-fighting drug. Deirdre purchased the stock over the past 12 years at an average price of \$23 compared to today's fair market value of \$98 a share.

Table 2 illustrates the overall tax savings if Deirdre takes a total distribution from her plan and immediately sells the assets received.

Tax rules for IRA and plan distributions are very complex and are changing all the time. It is very important to consider all taxes that could be paid over your lifetime and at your death (income, penalties and estate taxes). Sometimes a rule like this can seem attractive until it is measured against the tax deferral that you give up to use it. For these reasons, it is very important to seek advice from professional advisers who specialize in all issues that impact retirement planning.

There are several additional aspects of our example that you should take note of:

- Dierdre's situation is obviously such that she needs her money right away—the option of rolling over into an IRA has not been considered. For most people, however, this would be the preferable option.
- Dierdre could have done a partial rollover by transferring the mutual funds into an IRA and paid no tax on this portion of her plan distribution.
- Dierdre's capital gain is considered long term for the difference between the fair market value of the stock on the distribution date and her average cost basis. For stock sales after the distribution date but within one year of distribution, any additional gain above the fair market value on the distribution date is considered short term. All proceeds from sales one year or later after distribution are considered long-term capital gain.
- If Dierdre takes the stock and holds for future sale during her retirement, she may be taking

on significant investment risk by holding a substantial, non-diversified asset in her portfolio.

### DISTRIBUTIONS AFTER 70½

The tax-deferred growth and compounding effect that an IRA affords is an invaluable asset. But at age 70½, you must start taking withdrawals from traditional IRAs.

The date you must take your first withdrawal from a traditional IRA is called your 'required beginning date.' This date is April 1 of the year after the year in which you attain age 70½.

You may take your first mandatory withdrawal in the year you actually turn 70½, or by April 1 of the following year. Your second mandatory distribution must be made no later than December 31 of the year after you turn 70½. Therefore, if you choose to defer your first required distribution, you will be required to take both the first and second mandatory withdrawals in the year after you are 70½. Deferring the distribution may increase the taxes payable because the additional ordinary income may push you into a higher tax bracket. Multiple-year tax planning is recommended to determine the best strategy for the initial required distribution.

If you do not start taking mandatory withdrawals in the prescribed manner, the IRS will penalize you with a late distribution penalty. You are required to report and pay a 50% penalty on the difference between the amount you were required to withdraw and the amount you actually did withdraw. Use IRS Form 5329 to report the additional penalty.

How do you determine how much to withdraw?

The Internal Revenue Service has recently made this calculation much simpler. Table 3 indicates the divisor you use to calculate your annual mandatory withdrawal

**TABLE 3. MINIMUM DISTRIBUTION LIFE EXPECTANCY DIVISORS**

Life Expectancy Divisor		Life Expectancy Divisor	
Age	Divisor	Age	Divisor
70	27.4	93	9.6
71	26.5	94	9.1
72	25.6	95	8.6
73	24.7	96	8.1
74	23.8	97	7.6
75	22.9	98	7.1
76	22.0	99	6.7
77	21.2	100	6.3
78	20.3	101	5.9
79	19.5	102	5.5
80	18.7	103	5.2
81	17.9	104	4.9
82	17.1	105	4.5
83	16.3	106	4.2
84	15.5	107	3.9
85	14.8	108	3.7
86	14.1	109	3.4
87	13.4	110	3.1
88	12.7	111	2.9
89	12.0	112	2.6
90	11.4	113	2.4
91	10.8	114	2.1
92	10.2	115+	1.9

amount. However, if your account beneficiary is your spouse who is more than 10 years younger than you, you may use the actual "joint life expectancy" tables, which would yield a smaller required distribution. These tables can be found in IRS Publication 590.

The calculation process is as follows:

- (1) Gather the prior years' ending balances in all of your traditional IRAs, 401(k)s or other similar qualified tax-deferred accounts (this does not apply to defined-benefit pension plans, for instance, or Roth IRAs).
- (2) Find the life expectancy divisor for the age you will attain in the current year in the chart.
- (3) Divide the total of your balances by the divisor. The result is the amount you are required to withdraw from your deferred accounts. It does not matter from which IRA or retirement plan

account the withdrawal comes, as long as the amount is distributed before December 31 of the current year (or April 1 of the year following your first required distribution year). The distribution may be taken in a single sum or in a series of payments over the course of the tax year.

## ROTH DISTRIBUTIONS

While Roth IRAs are not subject to the minimum distribution requirements, not all distributions from them are tax-free and penalty-free.

When a distribution is made from a Roth IRA, it is characterized as being made in the following order, based upon the value of the account at the end of the year:

- Annual contributions

- Converted contributions
- Earnings

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

- They are made after you reach age 59½;
- They are made after your death;
- They are made on account of your disability; or
- They are used for qualified first-home purchases.

Non-qualified distributions are taxable to the extent of earnings after the recovery of your 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 to the 10% penalty for traditional IRAs also apply for Roth IRAs.

## BOTTOM LINE BASICS

As you can see, there are a variety of IRA distribution rules to be considered. This article was intended to help you familiarize yourself with the basics before taking distributions, so that you can better understand some of the issues that you will want to consider.

Because of the large sums of money involved in distributions—and the hefty penalties—it may be wise to seek out experienced advisers when dealing with some of these concerns. However, it is always important to do your homework. No one is going to care more about your retirement assets than you do. ♦

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