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Withdrawals from IRAs when the owner is under age 59½

by Marsha A. Goetting, Ph.D., CFP®, CFCS, Professor and Extension Family Economics Specialist, Montana State University-Bozeman; Kristen G. Juras, Esq. and Adjunct Professor, School of Law, University of Montana-Missoula

Describes the tax consequences that apply to withdrawals from IRAs and other qualified retirement plans when the IRA owner is under age 59½. Includes exceptions to the 10 percent early withdrawal penalty.

Individual Retirement Accounts (IRAs) are tax-advantaged savings plans available to people who meet certain eligibility requirements. IRA contributions are placed in custodial accounts at financial institutions, insurance companies, mutual funds or investment brokerage firms.

IRA owners who withdraw money from their traditional IRAs should consider the tax implications. Different tax consequences apply depending upon the IRA owner's age—under 59½, between ages 59½ and 70½, or over 70½. Other regulations govern the taxation of withdrawals made by beneficiaries after an IRA owner's death.

This MontGuide focuses on the rules about withdrawals from IRAs when the owner is under age 59½ and the circumstances under which the 10 percent early withdrawal penalty can be avoided. The MontGuide incorporates regulations generally effective Jan. 1, 2003, under the Economic Growth and Tax Relief Reconciliation Act of 2001. Three other MontGuides discuss withdrawals from IRAs:

1. Withdrawals from IRAs when the owner is between ages 59½ and 70½ and when owner turns 70½. (MT200309 HR)

2. Inheriting an IRA: Planning techniques for primary beneficiaries (MT200310 HR)

3. Inheriting an IRA: Planning techniques for successor beneficiaries (MT200311 HR)

If you have an existing qualified plan or IRA contract, review your documents carefully, as the rules may be different than the ones discussed here. Congress changes retirement laws frequently, so view this publication as a general guide.

General rules governing taxation of withdrawals from IRAs

A withdrawal of any amount during a tax year may be subject to federal and state income taxation depending on whether the account is a Roth IRA or a traditional IRA (that is either *tax deductible* or *non-tax deductible*). Similarly, taxation of withdrawals from qualified plans are determined by whether the plan consists of tax deductible or non-tax deductible contributions.

Roth IRA

Contributions to a Roth IRA are non-tax deductible and may be withdrawn at any time without federal or state income taxation. Distributions of earnings from a Roth IRA are not subject to state and federal income tax if the

distribution of earnings is made at least five years after the Roth IRA account has been established.

Example: Jim opened a Roth IRA on Jan. 1, 2003. He deposited \$2,000 on that date, \$3,000 on Jan. 1, 2004 and \$3,000 on Jan. 1, 2005. On Feb. 15, 2006 he has a balance of \$8,275 (\$8,000 in previous contributions, plus earnings of \$275). On Feb. 15, 2007, Jim withdraws \$4,000 from his Roth IRA. The distribution is treated as a withdrawal of his contributions, and is not taxable.

Example. On Feb. 1, 2009, Jim withdraws the balance in his Roth IRA, which is more than five years after he established it. The withdrawal consists partially of previous contributions and earnings on previous contributions. Because the withdrawal of earnings occurs more than five years after the Roth IRA account was established, none of the withdrawal is subject to federal or state income taxation. However, if Jim is under age 59½, the withdrawal of earnings is subject to a 10 percent penalty for early withdrawal, unless an exception applies (see "penalty exception rules").

Tax Deductible IRA

For state and federal income tax calculation purposes, the amount withdrawn from a traditional *tax deductible IRA* is added to the owner's income in the year withdrawn. If the withdrawal is made before the IRA owner is age 59½, a 10 percent penalty may apply, unless an exception to the penalty is available (as discussed in more detail in the "Penalty exception rules" section).

Example: Bruce, age 65, withdrew \$15,000 from his tax-deductible IRA. The \$15,000 is added to his other taxable income of \$29,000. Bruce pays state and federal income taxes on total income of \$44,000 (\$29,000 other taxable income + \$15,000 IRA withdrawal = \$44,000). The additional income puts Bruce in the 27 percent federal marginal tax bracket and the 10 percent Montana marginal tax bracket. Of the \$15,000 withdrawal, Bruce "lost" \$5,550 to state and federal income taxes.

Non-tax deductible IRA

Owners of *non-tax deductible IRAs* have distributions that consist partly of:

- (1) contributions that were already taxed (which establishes the IRA owner's cost basis in the IRA),
- (2) tax deductible contributions, and
- (3) earning or gains on the total contributions.

Non-tax deductible IRA owners who make withdrawals should complete Worksheet 1-1 in IRS Publication 590 to figure how much of their IRA distributions are tax free and how much are taxable. Information from the worksheet is entered on Form 8606 that is included with an IRA owner's federal and state income tax returns.

Withdrawals before an IRA owner is age 59½

IRAs were first established in 1974 as tax-deferred accounts designed to encourage Americans to save for retirement. Roth IRAs were established in 1998 for the same

purpose. For this reason the Internal Revenue Service (IRS) imposes a 10 percent penalty for withdrawals from traditional IRAs (whether *tax-deductible* or *non tax-deductible*) when the owner is under age 59½, as well as withdrawals from the *earnings* of a Roth IRA, unless the withdrawal falls under one of the following "exceptions."

Although an exception from the 10 percent penalty may apply to an early withdrawal, a withdrawal from a traditional IRA and the taxable portion of a withdrawal from a non-tax deductible IRA will still be subject to state and federal income taxation (review the discussion of the general tax rules applicable to tax-deductible and non tax-deductible IRAs above).

Roll-overs

Distributions from one IRA that are "rolled over" within 60 days into another IRA are not subject to income taxation or the 10 percent penalty. Special rules apply to roll-overs from traditional IRAs to Roth IRAs.

If the transfer is not directly deposited from one IRA account to another, the distribution is subject to a mandatory 20 percent withholding tax. For this reason, direct "trustee to trustee" transfers are often preferred to distributions that come into the control of the IRA owner. The roll-over rules also apply to distributions from one qualified plan to another qualified plan or to an IRA.

Penalty exception rules

Medical expenses

If an IRA owner or qualified plan participant takes a distribution from an IRA or qualified plan to pay for qualified unreimbursed medical expenses incurred in the year of distribution that are greater than 7.5 percent of adjusted gross income, then the 10 percent penalty is avoided.

Example: Benjamin has \$5,000 of qualified medical expenses in 2004 and withdraws \$4,000 from his IRA account to pay these

expenses. His adjusted gross income for 2004 is \$30,000. For income tax purposes, Benjamin can deduct only the amount of medical expenses that is above 7.5 percent of his income, or \$2,750. Whether or not Benjamin itemizes deductions on his 2004 return, \$2,750 of the distribution is exempt from the 10 percent penalty. The remaining \$1,250 from the IRA withdrawal is subject to the 10 percent penalty. In addition, the entire \$4,000 withdrawal is subject to federal and state income taxes.

Health insurance premiums

An unemployed IRA owner who makes a withdrawal to pay for health insurance premiums for him/herself, a spouse or dependents can avoid the 10 percent early withdrawal penalty. To qualify for this exception, an IRA owner must have received unemployment compensation under a federal or state law for at least 12 consecutive weeks.

Also, the distribution from an IRA must be made in either the year unemployment compensation is received or the following year. The withdrawal from an IRA cannot exceed the amount actually spent on health insurance premiums. This exemption from the 10 percent penalty does not apply to IRS qualified retirement plans.

First time home buyer expenses

Account owners may withdraw money from their IRAs without the 10 percent penalty if the funds are used within 120 days after the withdrawal for *qualified acquisition costs*. These costs are defined as the costs of acquiring, constructing or reconstructing a first home that is the principal residence of the IRA owner, his/her spouse, children, grandchildren or ancestors.

To be a first-time home buyer, neither the IRA owner nor his/her spouse can have ownership interest in a principal residence within the two years prior to withdrawal. The amount of home buyer expenses eligible under the exception rule is a lifetime maximum of up to \$10,000

per account owner. This exemption from the 10 percent penalty does not apply to IRS qualified retirement plans.

Higher education expenses

Funds may be withdrawn from a traditional or Roth IRA before age 59½ without the 10 percent penalty if the funds are used to pay “qualified higher education expenses” such as tuition, fees, books, supplies and computer equipment required for attendance. If the individual is at least a halftime student, room and board are qualified expenses. The expenses must be for the IRA owner or his/her spouse, children or grandchildren. This exemption from the 10 percent penalty does not apply to IRS qualified retirement pension plans.

Disability

If an IRA owner or qualified plan participant becomes disabled before reaching age 59½, amounts withdrawn are not subject to the 10 percent penalty. However, the withdrawal is subject to federal and state income taxes.

Death

Upon death of an IRA owner or a qualified plan participant, assets can be distributed to a beneficiary (including the IRA owner’s estate in the absence of a beneficiary designation) without incurring the 10 percent penalty on early distributions. However, the beneficiary must include the IRA distribution in his/her taxable income in the year of distribution. For larger estates, the balance of the IRA account as of the date of the IRA owner’s death may also be subject to federal estate taxes. As of Jan. 1, 2001, Montana no longer imposes an inheritance tax.

Equal payments based on life expectancy

If withdrawals are part of a series of substantially equal payments over the life of the IRA owner (based on life expectancy tables) or over the lives of the owner and the beneficiary

(joint life expectancies), then distributions from a traditional IRA before age 59½ can be made without the 10 percent penalty.

The IRA owner must use an IRS-approved distribution method and must take at least one distribution annually for this exception to apply. The exception for equal payments applies to a qualified plan only if the distributions begin after the employee separates from the employer’s service.

Qualified Plans—Special Rules

As noted above, several of the exceptions from the 10 percent penalty that apply to IRAs do not apply to IRS qualified retirement plans.

There are two exceptions from the 10 percent penalty available to qualified plans that are not available to IRA owners. A distribution from a qualified plan (but not IRAs) made to an employee after separation from service after age 55 is exempt from the 10 percent penalty. And, certain distributions made from a qualified plan to the participant’s spouse under qualified domestic relations order in a divorce or separation are also exempt from income taxation and the 10 percent penalty. Special rules apply to lump-sum distributions from IRS qualified retirement plans (but not IRAs). Consult your tax advisor for the application of these special rules.

Conclusion

The rules for withdrawing funds from an IRA remain complicated even under the *Economic Growth and Tax Relief Reconciliation Act of 2001*. Readers who have other types of retirement plans may find that the terms of their plan further restrict the rules discussed in this MontGuide. One option is to roll over their plan into an IRA. IRA owners and qualified plan participants should seek the assistance of a specialist, such as a Certified Public Accountant (CPA), Certified Financial Planner (CFP®), or an attorney who

specializes in taxes to ensure they are following rules established by the Internal Revenue Service.

Further information from MSU Extension

Additional MontGuides on Individual Retirement Accounts are available from the MSU Extension Service.

- Types of IRAs and changes resulting from the Economic Growth and Tax Relief Reconciliation Act of 2001: *Individual Retirement Accounts*, MT 199807 HR.

- Features to consider when *Shopping for an IRA*: MT 200207 HR.

- *Withdrawals from IRAs when the owner is between the ages of 59½ and 70½ and when owner turns 70½*: MT 200309 HR.

- *Inheriting an IRA: Planning techniques for primary beneficiaries* MT 200310 HR.

- *Inheriting an IRA: Planning techniques for successor beneficiaries* MT 200311 HR.

All five MontGuides are available free from your local MSU Extension Office. Or, send \$1 for handling to: MSU Extension Publications, PO Box 172040, MSU-Bozeman, 59717. The publications can also be downloaded without charge from the Web under retirement planning at <http://www.montana.edu/extensionecon/publications/confinpub.html> or under “Family Financial Management” at www.montana.edu/publications

Further information from the Internal Revenue Service

Individual Retirement Arrangements (Publication 590) is available from the Internal Revenue Service. For delivery via US Postal Service call 1-800-TAX-FORM (1-800-829-3676).

The publication can be downloaded at: <http://www.irs.gov>. Under **Search Forms and Publications**, type **590** and click **GO**.

Acknowledgment

Representatives from the following have reviewed this MontGuide and recommend its reading by all Montanans.

- Montana Credit Union Network
- Montana Society of Certified Public Accountants

Disclaimer

This publication is based on laws in effect as of September 2003. It is designed to provide educational information on IRAs, not to render legal, accounting or other professional advice. If legal advice or tax assistance is required, seek the services of a competent professional.



<http://www.montana.edu/wwwpb/pubs/mt200308.html>

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