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Distributions from Traditional IRAs: Between Ages 59½ and 70½

What is an IRA distribution?

A withdrawal from an IRA is referred to as a distribution. Distributions can come in the form of several payment patterns, from a one-time (lump-sum) payment to a series of distributions over a number of years. Depending on how old you are at the time of the distribution, the payment may be classified as a premature distribution (made prior to age 59½), a normal distribution (between ages 59½ and 70½), or a required minimum distribution (after age 70½). There are tax consequences to any type of traditional IRA distribution.

> **Caution:** This discussion pertains primarily to distributions from traditional IRAs. Qualified distributions from Roth IRAs are tax-free. Even Roth IRA distributions that don't qualify for tax-free treatment are tax free to the extent of your own contributions to the Roth IRA. Only after you've recovered all of your contributions are distributions considered to consist of taxable earnings. Further, special rules apply to distributions taken from Roth IRAs that have funds rolled over or converted from traditional IRAs.

> **Caution:** This article applies to distributions to IRA owners. Special rules apply to distributions to IRA beneficiaries.

IRA distributions subject to income tax

When you receive a distribution from your traditional IRA, the amount you receive is generally subject to income tax. If you have made nondeductible contributions to your traditional IRA, part of any distribution will be considered nontaxable.

> **Caution:** Taxable income from an IRA is taxed at ordinary income tax rates even if the funds represent long-term capital gains or qualifying dividends from stock held within the IRA.

Premature distribution tax does not apply

Once you reach the age of 59½, you are allowed (but not required) to take distributions from your IRA without being subject to the 10 percent premature distribution tax. You may choose to take distributions sporadically, as you need the money, or you may request an automatic distribution from your account according to a prearranged schedule you establish with your IRA administrator.

Withholding from IRA distributions

Federal income tax is withheld from distributions from traditional IRAs unless you choose not to have tax withheld. Generally, tax is withheld at a 10 percent rate. If you receive an annuity or similar periodic payment, tax withheld is based on your marital status and the number of withholding allowances you claim on your withholding certificate (Form W-4P). No withholding or waiver is needed when the distribution is a trustee-to-trustee rollover from one IRA to another. See the following section.

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IRA rollovers and transfers

In general

In general, there are two ways to transfer assets between IRAs, rollovers and trustee-to-trustee transfers. With a rollover, you receive funds from the distributing IRA and then complete the transfer by depositing the funds into the receiving IRA within 60 days A trustee-to-trustee transfer is a transaction directly between IRA trustees and custodians. If properly completed, rollovers and trustee-to-trustee transfers are not subject to income tax or the 10% premature distribution tax.

> **Tip:** You are still allowed to make your regular IRA contribution in a year when you have a rollover or trustee-to-trustee transfer.

> **Tip:** You can roll over (or transfer) funds from a traditional IRA to another traditional IRA or from a Roth IRA to another Roth IRA. Special rules apply to converting or rolling over funds from a traditional IRA to a Roth IRA. See "Converting traditional IRAs to Roth IRAs" below. You may also be able to roll over (or transfer) taxable funds from an IRA to an employer-sponsored retirement plan.

60-day rollover: you receive the funds and reinvest them

With a rollover (sometimes called an "indirect rollover"), you receive a distribution from your IRA and then, to complete the rollover, you deposit all or part of the amount distributed into the receiving IRA within 60 days of the date the funds are released from the distributing account.

> **Example(s):** On January 2, you withdraw your IRA funds from a maturing bank CD and choose to have no income tax withheld. The bank cuts a check payable to you for the full balance of the account. You plan to move the money into an IRA account at a competing bank. Fifteen days later, you go to the new bank and deposit the full amount of your IRA distribution into your new rollover IRA CD. Your rollover is complete.

If you don't complete the rollover transaction or miss the 60-day deadline, your distribution is taxable to you. However, the IRS is able to extend the 60-day period, in limited circumstances, when the failure to timely complete the rollover is not the taxpayer's fault.

> **Example(s):** Assume the same scenario as the first example, except that when you receive your check from the first bank, you cash the check and loan the money to your brother-in-law, who promises to repay you in 30 days. As it turns out, he doesn't pay back the loan until March 5 (the 62nd day after your withdrawal). You deposit the full sum into the IRA account at the new bank. However, because you didn't complete your rollover within the 60-day time period, the January 2 distribution will be taxable (excluding any nondeductible contributions, as described above).

> **Caution:** You are allowed to make a rollover from a particular IRA only once in a 12-month period. If you receive a second distribution from the same IRA within a 12-month period, you cannot roll it over (you also can't make a rollover from the IRA you roll the funds into for 12 months).

If you roll over part, but not all, of your distribution within the 60-day period, then only the portion not rolled over is treated as a taxable distribution.

When you take a distribution from your traditional IRA, your IRA trustee or custodian will generally withhold 10 percent for federal income tax (and possibly additional amounts for state tax and penalties) unless you instruct them not to. If tax is withheld and you then wish to roll over the distribution, you have to make up the amount withheld out of your own pocket. Otherwise, the rollover is not considered complete, and the shortfall is treated as a taxable distribution. The best way to avoid this outcome is to instruct your IRA trustee or custodian not to withhold any tax. Unlike distributions from qualified plans, IRA distributions are not subject to a mandatory withholding requirement.

> **Example(s):** You take a $1,000 distribution (all of which would be taxable) from your traditional IRA that you want to roll over into a new IRA. One hundred dollars is withheld for federal income taxes, so you actually receive only $900. If you roll over only the $900, you are treated as having received a $100 taxable distribution. To roll over the entire $1,000, you will have to deposit in the new IRA the $900 that you actually received, plus an additional $100. (The $100 withheld will be claimed as part of your credit for federal income tax withheld on your federal income tax return.)

Trustee-to-trustee transfer

A trustee-to-trustee transfer occurs directly between the trustee or custodian of your old IRA and the trustee or custodian of your new IRA. You never actually receive the funds or have control of them, so a trustee-to-trustee transfer is not treated as a distribution (and therefore the issue of tax withholding does not apply). Further, trustee-to-trustee transfers are not subject to the 60-day deadline, or the "once per 12-month" limitation.

> **Example(s):** You have an IRA invested in a bank CD with a maturity date of January 2. In December, you provide your bank with instructions to close your CD on the maturity date and transfer the funds to another bank that is paying a higher CD rate. On January 2, your bank issues a check payable to the new bank (as trustee for your IRA) and sends it to the new bank. The new bank deposits the IRA check into your new CD account, and your trustee-to-trustee transfer is complete.

Trustee-to-trustee transfers avoid the danger of missing the 60-day deadline, and are generally the safest, most efficient way to move IRA funds. Taking a distribution yourself and rolling it over only makes sense if you need to use the funds temporarily, and are certain you can roll over the full amount within 60 days.

Converting traditional IRAs to Roth IRAs

You may be able to convert your traditional IRA to a Roth IRA, but you will have to pay income taxes on the amount of the traditional IRA contributions you previously deducted and any earnings you withdraw. Generally, if you're over age 59½, withdrawals from your Roth IRA are considered to be qualified tax-free distributions once you satisfy a five-year holding period.

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Other types of distributions

Lump-sum distributions

A lump-sum distribution is one whereby you receive the entire balance of your account in one payment. The trustee or custodian of your IRA will withhold 10 percent of your balance for taxes unless you choose not to have taxes withheld. You must report your distribution for income tax purposes and are subject to regular income taxes on the distribution.

> **Caution:** The amount of your distribution is included in your income in the year received. A large enough lump-sum distribution could have the effect of causing a portion of your income to be taxed at a higher marginal tax rate (i.e., "pushing you into a higher tax bracket").

Discretionary distributions

Discretionary distributions do not follow a payment schedule and are considered non-periodic payments. Under this withdrawal scheme, you take distributions as the need arises. The IRA custodian or trustee will withhold 10 percent of your withdrawals for federal income tax unless you choose not to have tax withheld.

> **Example(s):** You have $55,000 in your IRA. You are age 60. You decide to take a distribution from your account to celebrate your 25th wedding anniversary with a cruise. You withdraw $10,000. You are subject to federal and state income taxes on the amount of the distribution. If you have made only deductible contributions to the IRA, the entire amount of the distribution is subject to tax. If you have made nondeductible contributions, a portion of the distribution will not be subject to tax.

> **Caution:** The amount of your distribution is included in your income in the year received.

Substantially equal periodic payments

You may have begun taking substantially equal periodic payments from your IRA before reaching age 59½ to avoid the 10 percent premature distribution tax (refer to Internal Revenue Code Sec. 72(t)). The rules for substantially equal payments require that you receive payments over your life expectancy (or the joint life expectancy of you and your designated beneficiary). The payments must occur at least annually. If you started taking substantially equal payments before age 59½, you can't modify the payments before five years from the payment start date or upon reaching age 59½, whichever is later. If you began receiving payments under this guideline and you increase or decrease the payment amounts before this period of time ends, the premature distribution tax generally applies retroactively to all distributions before age 59½.

> **Example(s):** Billy Bob, at age 57, needed some cash from his IRA and didn't want to pay the premature distribution tax, so he began receiving substantially equal payments from his IRA. The balance in his IRA at the time was $60,000, and according to the charts accepted by the IRS at the time, his life expectancy was 27.9 years. Based on this life expectancy and the IRA balance, and applying the level payment amount amortization method, the amount allowed each year under substantially equal payments was $5,435 (derived by amortizing $60,000 at 8

percent interest in level payments over 27.9 years). Three years later, on his 60th birthday, Billy Bob increases the distribution amount to $7,000. Because the substantially equal payments did not run for 5 years before the change, Billy Bob must pay the premature distribution tax on the full amount received from age 57 until age 59½.

Tip: One of the methods that can be used to calculate substantially equal periodic payments is effectively the same as that used to calculate required minimum distributions.

Should you withdraw money from your IRA between ages 59½ and 70½?

It depends on your circumstances. If you really need the money for income or unforeseen expenses, it may very well be advisable to draw on your IRA. However, if you have other sources of income and don't need the IRA funds, you may want to think twice about withdrawing funds. Even though you will be free of the premature distribution tax once you've reached age 59½, you still may have to pay income taxes on all or part of any IRA withdrawals (depending on whether or not the contributions you made were tax deductible). If the amount of a taxable distribution is substantial, it may even push you into a higher tax bracket for that year. This could increase your annual tax liability significantly.

In addition, if you take a number of large IRA distributions after reaching 59½, your IRA could be depleted (or at least reduced in size) more quickly than you had planned. This could mean a smaller nest egg for your later retirement years when you may need income the most, and a much smaller balance available to leave to your beneficiaries when you die. And, of course, the longer you leave funds in an IRA, the greater the opportunity for compounded, tax-deferred growth of earnings. The point is that it's often not wise or appropriate to take distributions from an IRA between ages 59½ and 70½.