IRA Rules And Early Distribution Penalty

Retirement plans, like IRAs and 401(k) plans, allow you to save for your future. However, if you don’t follow the plan rules, you might receive tax penalties for one of these:

* Contributing too much money in a year
* Withdrawing your money too soon
* Failing to withdraw your funds by the required minimum distribution date

You also might qualify for an exception to these penalties.

**Exceptions to early distribution penalties**

You usually put money into a tax-deferred savings plan to save for your future retirement. If you withdraw early, you might have a 10% early withdrawal penalty. You’re usually subject to the penalty if you withdraw money from your plan before age 59 1/2. However, there are exceptions to the 10% penalty.

The penalty doesn’t usually apply to distributions from your employer plan or IRA if any of these are true:

* You’re totally and permanently disabled.
* Your beneficiary receives the distribution from your retirement plan after your death.
* You receive distributions as a series of substantially equal periodic payments based upon either:
	+ Your life expectancy
	+ The joint life expectancies of you and your beneficiary
* You’re a qualified safety employee and you received the distribution:
	+ After separation from employment
	+ During or after the year you reach age 55 — or age 50

This exception doesn’t apply to IRAs.

* You use the distribution to pay medical expenses that are more than 10% of your adjusted gross income (AGI) — 7.5% if you or your spouse are age 65 or over.
* You received the distribution as a reservist or National Guard member if on active duty for at least 180 days.
* A federal tax levy forces your qualified plan or IRA to make a distribution.
* An alternate payee received the distribution under a qualified domestic relations order (QDRO). This exception doesn’t apply to IRAs.

IRAs have additional exceptions to the 10% penalty. The penalty for a distribution from your IRA doesn’t apply if:

* You use your IRA distribution to pay for health insurance premiums. Both of these must be true:
	+ You’re unemployed.
	+ You’ve received unemployment compensation for at least 12 consecutive weeks.
* You use your IRA distributions to pay for higher-education expenses.
* You use your IRA distributions of up to a $10,000 lifetime limit to buy, build, or rebuild a home for certain people. These people must not have had an ownership interest in a main home for at least two years. If this is true, you can use your IRA distribution for any of these people:
	+ Yourself
	+ Spouse
	+ Child
	+ Grandchild
	+ Ancestor

Even if you don’t pay a penalty, the taxable portion of the distribution will be taxed as ordinary income.

**Rolling over your employer-sponsored retirement-plan account**

You might roll over your company retirement-plan assets into an IRA. If you do, you might be able to take distributions and avoid the 10% penalty. However, the reverse can also be true.

Before rolling over your employer-sponsored retirement plan to an IRA, consider these:

* When you’ll need the funds
* The penalty exception(s) for the account you want to roll the funds into

If you roll over your plan assets, you’ll want to transfer the assets in a direct rollover. With a direct rollover, the plan administrator will send the rollover distribution directly to either the:

* Recipient IRA
* Employer plan

You might take a distribution and roll it over yourself. If so, the money you’ll receive will be the distribution amount minus the amount paid to the government. That amount is paid under mandatory federal income tax withholding. So, you’ll need to find money to equal the withholding to fund the rollover within the required 60 days. If you don’t fully fund the rollover within 60 days, you’ll pay a penalty.

**Special cases**

Rolling over your retirement plan distribution into an IRA prevents you from using certain rules. Ex: You won’t be able to use the special ten-year averaging rules if you:

* Were born before Jan. 2, 1936
* Are a beneficiary of a plan participant born before Jan. 2, 1936

If you don’t want tax withheld from a retirement plan distribution that isn’t a rollover, you must complete Form W-4P. If you don’t withhold tax, you might have to make estimated payments for your tax liability. Tax isn’t usually withheld if it’s reasonable to expect the distribution won’t be in your gross income.

**Rollovers**

If you roll over a distribution from your qualified retirement plan to an IRA, you have 60 days to complete this. The 60 days begins on the day you receive the check.

**Exception due to death**

If the IRA owner dies while there’s still money in the account, exceptions vary.

**Death and the traditional IRA**

Beneficiaries don’t have to worry about the 10% early withdrawal penalty. This applies regardless of the IRA owner’s or beneficiary’s age.

However, if the IRA owner would have paid tax, the beneficiary must also. This applies even though the beneficiary inherited the funds.

If you inherit the IRA from your spouse, you have the option to treat the IRA as your own. So, you can defer the minimum required distribution until you reach age 70 1/2. If you’re not a spouse, you might still qualify to receive distributions over your lifetime. You’d use the IRS life-expectancy tables to figure your required distributions over your life expectancy.

An entire IRA distribution might be subject to the five-year rule if:

* The IRA owner hadn’t designated a beneficiary.
* The deceased’s executors don’t designate a beneficiary by Sept. 30 of the year after the year of the IRA owner’s death.

**Death and the Roth IRA**

If you inherit a Roth IRA, the money is usually tax-free if it’s a qualified distribution. To be a qualified distribution, the funds must have been in the Roth account for five years before they’re withdrawn. The five-year holding period:

* Includes the amount of time the funds were in the account during the deceased’s lifetime
* Won’t start over when the beneficiary inherits the funds

If you inherit the Roth from your spouse, you can treat it as your own. So, there are no required withdrawals during your lifetime. However, if you’re not the deceased’s spouse, you’ll need to do one of these, depending on your situation:

* Take required minimum distributions from the account
* Use the five-year rule

**Getting your money early**

There are exceptions to the 59 1/2 rule. You can receive distributions from your traditional IRA without paying the 10% penalty. You can do this even if you receive the distributions before age 59 1/2.

To receive the distributions without a penalty, all of these must apply:

* The distributions must be part of a series of substantially equal payments based upon:
	+ Your life expectancy
	+ The joint life expectancies of you and your beneficiary
* You must use an IRS-approved distribution method.
* You must take at least one distribution annually.
* You must receive the distributions for at least five years and until you’re at least 59 1/2.

However, you’ll still have to pay tax on amounts not considered a return of your nondeductible contributions.

If you haven’t yet received payments for at least five years, you might have to pay the penalty. This applies even if you modify your method of distribution after reaching age 59 1/2. In that case, the tax applies only to payments distributed before you reach 59 1/2. There are also other exceptions.

**Minimum required IRA distribution**

You must begin withdrawing money from your traditional IRA by April 1 of the year after the year you reach age 70 1/2. The IRS will give you a 50% penalty on the amount not distributed if you don’t withdraw the minimum required amount.

If your 70th birthday occurs between January and June, you’ll turn age 70 1/2 before the end of that year. You must begin taking your required minimum distribution from your IRA by April 1 of the next year. However, you might want to take your first distribution in the year you turned age 70 1/2. This will let you avoid having to take two distributions in the next calendar year.

If your 70th birthday is after June 30, your first required minimum distribution would be the next year. You could wait until April 1 of the next year to take it.

Minimum withdrawals are based on life expectancy. So, first figure your minimum required distribution. Then, you can take the full amount from just one account or from several accounts.

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