

Tax-Deferred Accounts?

A look at IRS distribution requirements

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For anyone saving for retirement, IRAs, employer-sponsored savings plans, and annuities are often the vehicles of choice, since all offer tax-deferred compounding. Yet for all three investment vehicles, the IRS imposes certain restrictions on distributions and penalties if you do not meet the restrictions. With the help of your financial advisor, you can easily avoid these penalties by being aware of them before you invest. Following are summaries of the distribution requirements for all three tax-deferred accounts.

IRAs

For both Traditional and Roth IRAs, you may begin taking penalty-free distributions as soon as you reach age 59½. For traditional IRAs, any deductible contributions and investment earnings will be taxable at your then-current ordinary income tax rate. For Roth IRAs, qualified distributions will be tax free, provided you have held the account for at least five years. Any distribution you receive from an IRA before age 59½ will be subject to a 10% penalty tax imposed by the IRS, in addition to federal and state income tax.

There are, however, certain circumstances under which the IRS allows you to take a penalty-free distribution before age 59½:

- You become permanently disabled.
- You die before age 59½ and distributions are made to your beneficiary or estate after your death.
- You make withdrawals to pay deductible medical expenses that exceed 7.5% of your adjusted gross income.

- You make withdrawals for a qualified first-time home purchase (lifetime limit of \$10,000).
- You make withdrawals to pay qualified higher education expenses for yourself, a spouse, children, or grandchildren.

For Traditional IRAs, you must begin withdrawals by April 1 following the year in which you reach age 70½. Beyond this age, the IRS imposes **required minimum distribution (RMD)** rules that specify the minimum amounts you must withdraw each year, based on your age. If you have a spousal beneficiary who is more than 10 years younger than you, the RMDs can be based on the joint life expectancy of you and your spouse, permitting you to stretch out distributions and tax-deferred compounding. If your distributions in any year after you reach age 70½ are less than the required minimum, you will be subject to a penalty tax equal to 50% of the difference — so make sure you adhere to the RMD rules.

For Roth IRAs, you are not required to start taking distributions at age 70½, as you are with a traditional IRA. When a Roth IRA owner dies, however, his or her heirs must adhere to the same minimum distribution rules that apply to Traditional IRAs.

401(k)s, 403(b)s, and Other Employer-Sponsored Plans

As with IRAs, you may begin taking penalty-free distributions from your plan as soon as you reach age 59½. If you separate from service with your employer and you are at least 55 years old, you can also avoid paying the early withdrawal penalty. All earnings and before-tax contributions to the plan will be subject to ordinary federal and state income taxes as they are withdrawn at your then-current rate.¹ Prior to this, the same 10% penalty that applies to IRA early withdrawals will also apply and the IRS will require your employer to withhold 20% of the payment for income tax purposes.

As with a Traditional IRA, you must generally begin taking required minimum distributions no later than April 1 following the year in which you turn 70½. However, RMDs from a 401(k) can be delayed until retirement if you continue to be employed by the plan sponsor beyond age 70½ and you do not own more than 5% of the company.

The same age-based RMD rules also apply to employer-sponsored plans. Additionally, the IRS allows qualified individuals (born before 1936) to take a “lump-sum distribution” for which certain favorable tax rules apply. To qualify as a lump-sum distribution, you must receive all the amounts you have in all your retirement plans with a company (including 401(k), profit-sharing, and stock purchase plans) within a one-year period. If all the terms of the lump-sum distribution are met, the taxable part of the distribution is taxed at special rates based on levels for single taxpayers in 1986.

Some employer-sponsored plans may allow you to borrow as much as 50% of your vested account balance, up to \$50,000. In most cases, if you systematically pay back the loan with interest within five years, there are no penalties assessed to you. However, if you leave the company you must pay back the loan in full immediately. In addition, loans not repaid to the plan within the stated time period are considered withdrawals and will be taxed and penalized accordingly.

Annuities

As with IRAs, withdrawals from an annuity before age 59½ are taxed as ordinary income and will be subject to a 10% federal penalty tax. There are a number of exceptions to this penalty, including disability of the annuitant, a series of equal periodic payments for the life of the taxpayer (or taxpayer and beneficiary), or payments from an annuity where the payments start no more than a year after the purchase of the contract. At withdrawal, all investment earnings (but not contributions) on your annuity will be taxable at ordinary federal and state rates.

RMD rules do not apply to annuities, distributions from which can commence at any time after age 59½, as specified in the annuity contract. Keep in mind, however, that the issuing company may have its own set of rules and penalties. Annuity contracts often contain surrender charges for withdrawals taken during the initial years of the contract, so make sure to read the terms of your agreement closely.

As with all retirement and tax planning matters, be sure to consult a qualified tax and financial advisor to ensure that your planning decisions coincide with your financial goals.

Uniform Lifetime Table for Required Minimum Distributions

Age	70	75	80	85	90	95	100	105
	27.4	22.9	18.7	14.8	11.4	8.6	6.3	4.5

This table shows required minimum distribution periods for tax-deferred accounts for unmarried owners, married owners whose spouses are not more than 10 years younger than the account owner, and married owners whose spouses are not the sole beneficiaries of their accounts.

Source: IRS Publication 590.

Points to Remember

1. The IRS imposes certain restrictions on distributions from tax-deferred accounts and penalties if you do not meet the restrictions.
2. For IRAs and annuities, you may begin taking penalty-free distributions as soon as you reach age 59^{1/2}. For employer-sponsored retirement savings plans, you can also avoid paying the early withdrawal penalty if you separate from service with your employer and you are at least 55 years old.
3. For traditional IRAs, you must begin withdrawals by April 1 following the year in which you reach age 70^{1/2}. Beyond this age, the IRS imposes required minimum distribution (RMD) rules that specify the minimum amounts you must withdraw each year, based on your age.
4. The required minimum distributions from a 401(k) can be delayed until retirement if you continue to be employed by the plan sponsor beyond age 70^{1/2} and you do not own more than 5% of the company.
5. RMD rules do not apply to annuities, distributions from which can commence at any time after age 59^{1/2}, as specified in the annuity contract.
6. Annuity contracts often contain surrender charges for withdrawals taken during the initial years of the contract.

For more information, please consult with your financial advisor.

Important Additional Notes

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¹ The IRS allows for "in-kind" distributions of publicly held company stock in a plan, whereby any price appreciation which occurred while the securities were held in the 401(k) can be treated as capital gains rather than ordinary income.

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