Playing by the IRA Rules

Individual Retirement Accounts (IRAs) offer favorable tax-deferral benefits to individuals who are saving for retirement. But with those benefits, there are certain rules about when distributions may be taken to avoid penalty taxes. Contributions to a traditional IRA, depending on your income and participation in employer-sponsored plans, may entitle you to certain current income tax deductions. Further, because your funds are not taxed until distributions begin, your savings have the potential for tax-deferred growth. Generally, IRAs are designed to work as long-term savings vehicles, but you may be able to withdraw funds early and without penalty, provided your situation qualifies as an exception.

The Age 59½ Rule

The age 59½ rule provides that, if you take distributions from your traditional IRA before you reach the age of 59½, you may be subject to a 10% Federal penalty tax in addition to regular income tax. However, you may not have to pay the penalty tax if your early distribution meets certain requirements.

Exceptions

You may be eligible for penalty-free qualified distributions, if one of the following exceptions applies:

1. You are taking distributions as the beneficiary of a deceased IRA owner. Generally, if you inherit an IRA, you are required to take required minimum distributions (RMDs) over a period no longer than your life expectancy. For nonspousal beneficiaries, RMDs must begin in the year following the year in which the IRA owner died.

   Spousal beneficiaries may have additional time to begin taking RMDs, depending on certain factors, including whether they opt to treat an inherited IRA as their own. This penalty tax exception does not apply to spousal beneficiaries who opt to treat the account as their own IRA.

2. You are paying for certain first-time homebuyer expenses, generally referred to as qualified acquisition costs, such as buying, building, or renovating a first home. Distributions, which may not exceed $10,000, may be used to cover qualified costs for you, your spouse, your children, or your grandchildren.

3. You, your spouse, or dependents have unreimbursed medical expenses that total more than 10% of your adjusted gross income (AGI) (7.5% if you are age 65 or older, but only through 2016). If a medical expense for you, your spouse, or a dependent qualifies as an itemized deduction on your income tax return, it will generally qualify for this penalty tax exception.

4. The distributions are part of a series of substantially equal periodic payments (SEPPs) made at least annually that meet certain additional requirements. The Internal Revenue Service (IRS) currently recognizes three methods for calculating SEPPS: the required minimum distribution method, the fixed amortization method, and the fixed annuitization method.

5. Once SEPPs begin, they must be made for five years or until you reach age 59½, whichever is later.

6. You qualify with certain physical and/or mental conditions as being disabled, determined by a physician and if the disability can be expected to result in death or continue for an indefinite duration.

7. You are paying medical insurance premiums due to unemployment. If you lost your job, and received unemployment compensation for 12 consecutive weeks, you may take distributions from your IRA account, penalty tax free, during the year in which you received unemployment compensation, or in the following year, but no later than 60 days after you have been re-employed.

8. You are paying for higher education expenses, such as tuition, fees, and books at an eligible educational institution (generally all accredited postsecondary institutions). The distributions may not exceed your qualified education expenses, or those of your spouse, your children, or your grandchildren.

9. The distribution is attributable to an IRS levy of the IRA.

10. Reservists qualify while serving on active duty for at least 180 days.

IRAs are strictly regulated to ensure that they are used as vehicles for retirement savings. Therefore, they generally work best as long-term savings vehicles. However, if you do need income from your IRA before you reach age 59½, it is important to know if your situation excuses you from the penalty tax levied on early distributions before making a withdrawal. Playing by the rules may save you money and help preserve your savings for retirement. Be sure to consult your tax advisor to determine whether your individual situation will qualify as an exception.