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White Paper

Distributions from Traditional IRAs Prior to Age 59½

www.selectportfolio.com • Toll Free 800.445.9822 • Tel 949.975.7900 • Fax 949.900.8181

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Table of Contents

Distributions from Traditional IRAs Prior to Age 59½.....	3
In general	3
Example showing the effect of taxes and penalties	3
Exceptions to the premature distribution tax	4
How do you pay the premature distribution tax?	5
Should you take distributions from your traditional IRA before age 59½?	5
IRA rollovers	6
Converting or rolling over traditional IRAs to Roth IRAs	7
Disclosures	8

Distributions from Traditional IRAs Prior to Age 59½

In general

A withdrawal from an IRA is generally referred to as a distribution. If you receive a distribution from your traditional IRA before you reach the age of 59½, the federal government considers this a premature distribution. Like all distributions from traditional IRAs, premature distributions are generally taxable. You will pay federal (and possibly state) income tax on the portion of the distribution that represents tax-deductible contributions, any pre-tax funds that were rolled over into the IRA from an employer-sponsored retirement plan, and investment earnings. In addition to regular income tax, distributions taken prior to age 59½ may be subject to a 10 percent federal penalty tax (and possibly a state penalty) on the taxable portion of the distribution. You can avoid this federal penalty (known as the premature distribution tax) only if you are age 59½ or older at the time of the distribution, or if you meet one of the exceptions allowed by the IRS (see below).

You're probably wondering why your age at the time of distribution should matter and possibly result in a penalty on the distribution. The purpose of IRAs and retirement plans is to provide income to help fund your retirement years, and the federal government wants to make sure you use the money for that purpose. To accomplish this goal, the government imposes a penalty tax on taxable distributions taken before age 59½. The penalty tax encourages you (and other IRA owners and plan participants) to leave your money in the IRA or plan until that age or later. This, in turn, reduces the risk that you will deplete your funds prematurely and run out of money at some point in retirement. The assumption is that by the time you reach age 59½, you are either already retired or near retirement and can safely begin using your retirement money.

Tip: Roth IRAs are subject to special rules with regard to the premature distribution tax. For more information, see Roth IRAs.

Caution: Special rules apply to qualified individuals impacted by Hurricanes Katrina, Rita, and Wilma (see Special Hurricane and Other Disaster Distribution Provisions) and to qualified reservist distributions.

Example showing the effect of taxes and penalties

Income taxes on IRA and retirement plan distributions can really add up. When a distribution is also subject to the 10 percent federal penalty, the portion of the distribution that goes into your pocket obviously dwindles even further. To illustrate the possible effect of taking a distribution before age 59½, consider the following scenario.

Example(s): Joe retired on his 59th birthday. On that day, he withdrew the entire balance in his traditional IRA valued at \$100,000. The entire distribution was taxable. Because Joe also had considerable income from working that year, the IRA distribution was taxed in the maximum 35

percent federal income tax bracket. That came to \$35,000 in federal income tax (assuming no other variables). Joe was in the 9.3 percent state income tax bracket, so that meant another \$9,300 in state income tax. Since Joe was under age 59½ and no exception to the premature distribution tax applied to him, he had to pay \$10,000 in federal penalties (the 10 percent federal penalty tax), plus another \$2,500 in state penalties (due to a 2.5 percent state penalty). He ended up paying \$56,800 in taxes and penalties, leaving only \$43,200 for his own use.

If Joe had waited until he was 59½ or older to take his distribution, he would have avoided the federal and state penalties and saved \$12,500. Also, if he had waited two months until the next year (when he had no taxable income from working), the distribution might have been taxed in a lower income tax bracket. It would definitely have paid for Joe to get tax advice before taking that distribution from his traditional IRA.

Of course, if Joe had ever made any nondeductible contributions to his traditional IRA, the portion of his distribution that represented nondeductible contributions would not have been taxable because those contributions had already been subject to tax. That portion of his distribution would not have been subject to the 10 percent federal penalty either, since the penalty applies only to the taxable portion of a premature distribution.

If you are close to age 59½ and wish to take a distribution from your traditional IRA, check the calendar carefully to avoid a potentially costly mistake.

Exceptions to the premature distribution tax

Remember, only the taxable portion of a premature distribution is subject to the 10 percent federal penalty. This means that if you ever made any nondeductible (after-tax) contributions to your traditional IRA, a portion of your distribution may not be subject to tax or penalty. In addition, the IRS grants certain exceptions to the 10 percent federal penalty on distributions taken before age 59½. Premature distributions taken from a traditional IRA under the following circumstances will not be subject to the penalty:

- Your beneficiary (or estate) is receiving the funds after your death, regardless of your beneficiary's age or your age at the time of your death
- You are receiving the funds due to your qualifying disability (IRS definition of disability must be met)
- You are taking the distributions under one of the three annuity formulas approved by the IRS (often referred to as substantially equal periodic payments)
- You are paying unreimbursed medical expenses in excess of 7.5 percent of your adjusted gross income (AGI) for the year
- You are paying health insurance premiums for you, your spouse, or your dependents during a year in which you collected unemployment benefits for more than 12 consecutive weeks
- You make a qualifying, nontaxable rollover (or direct transfer)

- You are using the funds for the qualified higher education expenses of yourself, your spouse, your children, your spouse's children, your grandchildren, or your spouse's grandchildren
- You are using the funds to pay the first-time homebuyer expenses of yourself, your spouse, your children, your grandchildren, or an ancestor of your spouse or you (\$10,000 lifetime limit)
- The IRS is levying on your IRA to cover your unpaid federal income tax liability
- Your distribution is a qualified reservist distribution

Some of the above exceptions may need further explanation. If so, see Premature Distribution Rule. You should also consult a tax advisor regarding your situation to make sure which exceptions (if any) you qualify for. Finally, if you participate in an employer-sponsored retirement plan, be aware that different exceptions to the premature distribution tax may apply.

How do you pay the premature distribution tax?

The 10 percent federal penalty on premature distributions is reported and paid on your federal income tax return for the year in which you received the distribution. You must complete and attach Form 5329, titled Additional Taxes on Qualified Plans (including IRAs) and Other Tax-Favored Accounts. If you receive a premature distribution but qualify for one of the exceptions described above, see Form 5329 for instructions.

Should you take distributions from your traditional IRA before age 59½?

You are allowed to take distributions from your traditional IRA whenever you like and in any amount you choose. That does not mean, however, that you should take distributions. As a general rule, it is not advisable to take distributions from a traditional IRA before age 59½ (or for that matter, at any age prior to your retirement). First, as illustrated above, the portion of the distribution that goes to the federal government for taxes can be substantial--not to mention state taxes and penalties. This is especially true if the entire distribution will be taxable, and if none of the exceptions to the premature distribution tax apply to you.

In addition, even if all or some of the distribution will not be taxed or penalized, taking IRA distributions before age 59½ is still generally not wise. By dipping into your IRA funds at a relatively young age, you run the risk of depleting those funds sooner than you had anticipated. This could jeopardize your retirement goals and financial security later in life. Funds removed from an IRA may also be missing out on several years or more of potential tax-deferred growth, depending on investment performance.

However, the decision of whether to tap into your IRA nest egg ultimately depends on your individual circumstances. Perhaps you have urgent expenses, and withdrawing from your IRA is the only way you can pay them. It is also possible that you have accumulated large balances in your IRAs and other retirement accounts, so that withdrawing from your IRAs now will not pose a risk to your future financial security. In these cases, taking distributions before age 59½ is not necessarily ill-advised. Whatever your situation, though, you should consult a tax professional before taking a distribution.

IRA rollovers

In general, a rollover is the movement of funds from one retirement savings vehicle to another—in this case, from one traditional IRA to another. Rollovers are treated separately from contributions; you are still allowed to make your regular IRA contribution in a year when you have a rollover transaction. There are no age restrictions regarding rollovers, but there are other specific rules that must be followed. For example, a rollover generally must be completed within 60 days of the date the funds are released from the distributing account. If properly completed, rollovers are not subject to income tax or the premature distribution tax. There are two possible ways that IRA funds can be rolled over.

Tip: You can roll over funds from a traditional IRA to another traditional IRA or you can rollover funds 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 or rolling over traditional IRAs to Roth IRAs," below. You may also be able to roll over taxable funds from an IRA to an employer-sponsored retirement plan.

You receive the funds and reinvest them

With this method, you actually receive a distribution from your traditional IRA. To complete the rollover transaction, you make a deposit into the IRA that you want to receive the funds. You are allowed to do this 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). Also, you must deposit the full amount distributed to you within the allowable 60-day period. If you fail to complete the rollover or miss the 60-day deadline, all or part of your distribution will be subject to income tax and possibly the premature distribution tax.

Example(s): On January 2, you withdraw your IRA funds from a maturing bank CD. The bank cuts a check payable to you for the full balance of the account (assuming you opt for no income tax withholding). You plan to move the funds 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. Your rollover is complete.

Now assume the same scenario as above, except that when you receive your check from the first bank, you cash the check and lend the money to your brother, who promises to repay you in 30 days. As it turns out, he doesn't repay the loan until March 5 (the 62nd day after your distribution). You deposit the full sum into the IRA account at the new bank. However, because you didn't complete your rollover within 60 days, the January 2 distribution will be taxable (excluding any nondeductible contributions, as described above) and possibly subject to the premature distribution tax.

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. You fail to tell your IRA trustee not to withhold any tax, so \$100 is withheld for federal income tax and 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.)

Tip: The 2001 Tax Relief Act allows the IRS to extend the 60-day period, in limited circumstances, when the failure to timely complete the rollover is not the taxpayer's fault.

Trustee-to-trustee transfer

The second type of rollover transaction occurs directly between the trustee or custodian of your old traditional IRA, and the trustee or custodian of your new traditional 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). Trustee-to-trustee transfers avoid the danger of missing the 60-day deadline, and are not subject to the "once per 12 month" limitation.

Example(s): You have a traditional 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.

This is 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 or rolling over traditional IRAs to Roth IRAs

Have you done a comparison and decided that a Roth IRA is a better savings tool for you than a traditional IRA? If so, you may be able to convert or roll over an existing traditional IRA to a Roth IRA. However, be aware that you will have to pay income tax on all or part of the traditional IRA funds that you move to a Roth IRA. It is important to weigh these tax consequences against the perceived advantages of the Roth IRA. This is a complicated decision, so be sure to seek professional assistance. For more information, see Roth IRA and Converting or Rolling Over Traditional IRAs to Roth IRAs.

Tip: When you convert or roll over a traditional IRA to a Roth IRA prior to age 59½, the taxable portion of the funds is not subject to the premature distribution tax. However, special rules may apply if you withdraw from the Roth IRA within five years of the conversion or rollover. For more information, see *Converting or Rolling Over Traditional IRAs to Roth IRAs* and consult a tax advisor.

Disclosures

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

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