UNIVERSITY OF ILLINOIS EXTENSION

Your Retirement SERIES

Rules for Taking Distributions from Tax-Deferred Retirement Savings Plans

Putting money into an employer's retirement plan or IRA is just the first step toward financial security in retirement. How you withdraw the money also requires careful decision- making.

If you are enrolled in an employer's retirement savings plan, such as a 401(k), 403(b), or a defined benefit pension plan, or if you have an IRA, SEP or Keogh, you or your heirs must decide how to withdraw those funds. You have enjoyed the benefit of deferring taxes on both your contributions to the plans and the earnings on those contributions. But taxes and possible penalties apply when you take money out.

This fact sheet introduces the choices and rules involved in taking distributions from *tax-deferred* savings vehicles. Roth accounts, which have different rules and offer *tax-exempt* earnings, are discussed on page 3.

Use this information as only a guide; rules can change, and plans may offer only some of the options described here.

Age at Time of Distribution

Withdrawals from retirement accounts are called distributions. Distributions from tax-deferred retirement plans are subject to federal income tax, as you did not pay taxes on the contributions or earnings. Rules for distributions are based on the account owner's age. Penalty taxes may be owed if distributions are not taken according to the rules, as shown in Table 1.

Distributions before age 59½ may incur a 10% early distribution penalty tax. Exceptions to the penalty are summarized in Table 2. Although profit sharing or 401(k) plans may allow hardship withdrawals, these distributions are not an exception to the 10% early distribution penalty.

Beginning the year you turn 70½, you must take a minimum distribution for each year to avoid penalties. If you do not take your first distribution during the year you reach age 70½, you must take it by April 1 of the following year. This is referred to as your *required beginning date*. Distributions for all other years must be taken by December 31st.

Table 1: Taxes and Penalties on Distributions from Tax-Deferred Retirement Plans* **			
Age	***Federal Income Tax****	***Penalty Tax***	***To Avoid Penalties***
Under 59½	Taxed at your marginal rate.	10% early distribution penalty (25% for distributions taken from SIMPLE plans during first two years of participation) unless exception applies. See Table 2.	Rollover to an IRA or another employer plan within 60 days of distribution. During the first two years of participation in a SIMPLE IRA, only rollovers to another SIMPLE IRA will avoid taxes and penalties.
59½ to 70½	Taxed at your marginal rate.	No penalties apply.	NA
70½ and over	Taxed at your marginal rate.	50% penalty on any minimum distribution amount not taken. Penalty may be waived under certain circumstances.	Withdraw required minimum distribution each year; first distribution by April 1 of year following year in which you reach age 70½; second distribution by Dec. 31 of that same year. If you work past age 70½, there may be exceptions.

* Different rules apply to Roth accounts. See ***Different Rules for Roth Accounts*** on p. 3.

** Early distribution penalties do not apply to 457 plans. Distributions from 457s may not be made prior to age 70½ except in case of unforeseeable emergency, separation from service, or small inactive accounts.

*** State income tax treatment varies by state.

Example: When must I begin taking distributions?

Cate will turn 70 on July 4, 2015 and 70½ on Jan. 4, 2016, so her first required distribution will be for 2016. She can take it anytime during 2016 or as late as April 1 of the following year—April 1, 2017. She plans to take the distribution in March 2017. She must take her next distribution, for 2017, by December 31, 2017.

Eve turned 70 on May 30, 2010, and 70½ on Nov. 30. She took the 2010 distribution on October 1, 2010 even though the deadline was April 1, 2011. She took her second distribution—for 2011—on December 5, 2011.

Cate will owe income tax for two distributions on her 2017 taxes, which could put her in a higher tax bracket for that year. Eve paid tax on one distribution in 2010 and one in 2011.

When do you have to take your first distribution? Calculate your date here:

Your 70th birthday:

__________ ___, *20____*

Date you reach 70½:

__________ ___, *20____*

Take your first distribution during the year you turn 70 ½ or by April 1 of the following year:

April 1, 20____

Second distribution by:

December 31, 20____

Table 2: Distributions Exempt from the 10% Early Distribution Penalty*		
Reason for Distribution	***Type of Retirement Plan***	
	IRAs: ▪ *Traditional* ▪ *SEP* ▪ *SIMPLE* ▪ *Roth*	▪ *Qualified Plans, including 401(k)s* ▪ *403(b) Plans*
Participant's death	Yes	Yes
Participant's disability	Yes	Yes
Participant's separation from service after age 55	No	Yes
Distributions part of a series of substantially equal periodic payments	Yes**	Yes—only following separation from service
Distribution to cover medical expenses exceeding 7.5% of adjusted gross income	Yes—and for medical insurance premiums when unemployed**	Yes
Payment to alternate payee under a Qualified Domestic Relations Order (QDRO)	No—unless transferred directly to the former spouse's IRA	Yes
First-time home-buyer expenses (up to $10,000 lifetime maximum) for self, spouse, children, grandchildren, parents or ancestors	Yes**	No
Qualified higher education expenses for self, spouse, children, or grandchildren	Yes	No
Distributions due to an IRS tax levy on the plan or IRA	Yes	Yes

* Early distribution penalties do not apply to 457 plans.

** See IRS Publication 590, Individual Retirement Arrangements for details

Roth IRAs and Designated Roth Accounts in 401(k), 403(b) and Governmental 457 Plans

Rules for distributions from Roth accounts differ from those for tax-deferred plans. Contributions to Roth accounts are never taxed when distributed. *Qualified* distributions of earnings are not subject to tax or penalty. Distributions from Roth IRAs are treated as coming first from contributions, but distributions from designated Roth accounts in 401(k), 403(b), and governmental 457 plans are allocated between contributions and earnings.

Qualified distributions must meet two criteria:
1) a five year requirement (from first year of participation or Roth IRA contribution).
2) be made:
- after age 59½,
- due to owner's death or disability, or
- *Roth IRAs only:* for qualified first-time home buyer expenses, up to a lifetime maximum of $10,000.

If you are not yet age 59 ½, you may be able to avoid the 10% early distribution penalty on earnings if one of the exceptions in Table 2 applies.

Designated Roth accounts are subject to the standard required minimum distribution rules explained later in this document while Roth IRAs have required minimum distributions only for heirs, not for account owners.

Types of Distributions

Lump-Sum Distributions, Rollovers, and Conversions

You may be able to take the value of your retirement plan in a lump sum when you change jobs or when you retire, but you will owe income tax on the full amount in that year. The risk that you face when you take your money in a lump sum rather than taking annual distributions or annuitizing is that you may outlive your money. You will also probably pay more tax than if you take annual distributions, and you will lose additional years of tax deferral.

To delay taxes, roll the money into another retirement account or an IRA. Even in retirement, you can roll over money from one IRA to another. You can typically roll over both lump sum and partial distributions, if the distribution is not part of a required minimum distribution or a series of equal distributions used to avoid early distribution penalties.

How you set up the rollover has important consequences:

Trustee-to-trustee transfer from one IRA to another, or ***direct rollover*** from an employer retirement plan to an IRA or another retirement plan:

- If the money is transferred directly to the new account, the tax-deferred status is preserved and there is no withholding.

***Indirect rollover*:**

- If the funds are paid to you rather than directly to the new IRA or retirement plan, you must roll the money into another IRA or employer plan within 60 days to avoid taxes and penalties.
- Employer plans must withhold 20% for income taxes. If you roll over only the remaining 80%, you will be taxed and perhaps assessed a penalty on the 20% that was withheld. To avoid all taxes and penalties, you must deposit the full amount of your old plan into your new account. You will have to replace the 20% that was withheld with other money and wait until you file your income taxes to seek a refund of the withheld amount.
- After an indirect rollover between two IRAs, you will not be able to make another rollover involving either of these accounts for one year.

Conversions: You can convert money from a traditional IRA or an employer plan to a Roth IRA. Within an employer's plan, you can also convert from a regular account to a designated Roth account. Future earnings will be tax free. You pay taxes on the conversion except for previously taxed amounts, such as nondeductible IRA contributions. If you have made nondeductible contributions, you must calculate the proportion of your combined traditional IRA account balances that are from nondeductible contributions; that proportion of the conversion will be tax-free.

No early distribution penalty is owed on a conversion. You must re-deposit the money into the new account within 60 days. You can convert portions of an account in different years to avoid having the entire amount taxed in one year.

Conversions can be "undone" or recharacterized under certain circumstances. See IRS Publication 590 for details.

Example: Ann decides to move the money in her former employer's 401(k) to the 403(b) at her new job. She fills out papers authorizing the money to be transferred directly into her new employer's plan.

Are taxes withheld? No. It was a trustee-to-trustee transfer.

Example: Fred is changing jobs. He has decided to move the $10,000 in his old job's 401(k) to an IRA. He receives a check, made out to him, that he deposits into an IRA. Does the employer withhold taxes from the 401(k) money?

Yes. The employer will withhold 20% because the money was not transferred directly to the IRA. Fred's check will be for $8,000. Only the money that Fred deposits into the IRA within 60 days qualifies as a rollover. If he only deposits $8,000, he will owe taxes on the other $2,000. He might also owe a 10% early distribution penalty if he is not yet 55. (Age 55 and separated from service is an exception to the age 59½ requirement). Fred could add $2,000 from another source so that he can deposit $10,000—the amount of the distribution from the 401(k)—to avoid all taxes and penalties. He can get a refund of the withholding when he files his taxes.

Example: Marge has two IRAs. Contributions to one of them were all non-deductible. Can Marge convert just the non-deductible contributions to a Roth IRA?

No. Marge must calculate the percent of her combined balances in both IRAs that is from non-deductible contributions. Only that proportion of the conversion will be tax-free.

Planning Tips

- Choose direct rollovers and trustee-to-trustee transfers rather than indirect rollovers to avoid the 20% withholding and the risk of missing the 60-day rollover period. Don't risk losing the money's tax-deferred status and having to pay taxes on the full amount.
- Once you roll over money from an employer plan into an IRA, the funds are under IRA rules for distributions.
- If you borrow money from your plan and leave your job before paying it all back, the unpaid part of the loan is treated as a distribution. You will owe taxes and perhaps penalties on that amount.
- You can avoid required minimum distributions from tax-deferred plans by converting the money to a Roth IRA. You must take your required distribution for that year before converting. Roth IRAs have no required minimum distributions for account owners, although there are required distributions for heirs. Qualified distributions of future earning will be tax-free.
- Married persons have legal rights to their spouse's employer retirement plan. These rights can be waived in writing. Don't give up this important property right without serious consideration.

Annual Distributions

Retirement plans often offer annual distributions as an alternative to taking a lump sum when you retire. This allows you to take a part of the money from the account each year, spreading the taxes over the remainder of your lifetime and perhaps that of your heirs.

If you are under age 59½, you can choose regular, annual distributions as a way to access money in your IRA or former employer plan and avoid the early distribution penalty.

Once you reach age 70½, you are required to take minimum annual distributions calculated by using a factor from the IRS Uniform Lifetime Table. If your spouse is more than 10 years younger than you, a different table allows smaller required distributions. Both tables are in IRS Publication 590. To determine the minimum distribution each year, divide the balance in your account at the end of the previous year by the Withdrawal Factor for your age from the IRS table. You can always withdraw more than the minimum amount. If you withdraw less, you will owe a penalty of 50% of the amount you failed to withdraw. Taking more than the minimum amount in one year will not reduce the amount you must take in the following year.

Example: John is 78 this year. His spouse is 8 years younger. He has two IRAs. The balances as of Dec. 31 of last year were $21,000 and $9000. Using the Uniform Lifetime Table, his Distribution Period is 20.3. He adds the IRA balances together ($30,000) and divides by 20.3, resulting in a required minimum distribution of $1478, which he can take from either one of the IRAs, or take a portion from each account.

If you work past age 70½, you may delay distributions from your current employer's plans until you retire. This does not apply to plans of previous employers or IRAs. Also, owners of more than 5% of a company are not allowed to delay their minimum distributions past age 70½.

Through the end of 2013, persons aged 70 ½ or older can make tax-free distributions from traditional or Roth IRAs to qualified charitable organizations, with a maximum annual limit of $100,000. Distributions must go directly from the plan to the charity. These distributions will count as your required annual distribution.

Planning Tips

- A minimum distribution is just that—a minimum. You can always withdraw more.
- Balances in your traditional IRAs are added together to determine your minimum distribution, but you can take it all from one IRA or withdraw from several. Multiple 403(b) account balances are also added together. Distributions from profit sharing and 401(k) plans are each calculated separately.
- Consider your health, life expectancy, and income needs to decide whether to choose annual distributions, a lump sum, or an annuity.

Annuitized Payments

Rather than taking your money in a lump sum or in annual payments that will vary from year to year, you may have another choice: an annuity that guarantees payments for your lifetime, the joint lifetime of you and a beneficiary, or your lifetime with a guaranteed number of payments if you die earlier. If your plan doesn't offer annuitization, you might roll the money to an IRA that does.

Defined benefit plans, some defined contribution plans, and 403(b) plans must offer annuities that provide survivorship benefits to spouses of plan participants. Annuitized payments are the default method of payment for defined benefit plans.

When the participant retires, the employer must offer a *qualified joint and survivor annuity* that will pay the spouse a specified percent of the participant's annuity if the spouse survives the participant. The plan must also offer a *qualified pre-retirement survivor annuity* that will pay benefits to the spouse if the participant dies before retirement. These spousal rights are guaranteed unless the spouse waives them in writing.

The main advantage of annuitizing is that you won't outlive your money. However, annuities carry their own risks. You may die early and get very little of your investment back. Your spouse could die first, after you have chosen a joint and survivor annuity with its smaller monthly payments. Inflation will reduce the value of your annual payments over time. And you will no longer have access to the balance in your account for emergencies or to leave to heirs.

Choosing to annuitize your retirement benefits uses an *immediate* annuity. This is different from a *deferred* annuity, an investment product that may be one of your choices while you are contributing to your retirement plan. Deferred annuities are also sold directly by insurance companies. You invest money for either fixed or variable returns and defer tax on those returns. Retirement plans already provide tax-deferral on both contributions and earnings, so annuities inside retirement plans offer no additional tax benefit. You can choose other investments in your retirement plan, such as mutual funds, that have lower costs than annuities, and you will still have the choice of annuitizing at retirement.

Planning Tips

- If your annuity payment does not increase with inflation, an income that is generous in the beginning will buy less and less as the years pass.
- Current interest rates affect the amount of the monthly payment you get when you annuitize. Lower interest rates result in smaller monthly benefits.
- Immediate annuities may be a useful tool for retirement income planning, but you should never lock up all your money in annuities.

Social Security and Distributions from Employer Retirement Plans

Integration with Social Security: Some employer plans subtract part of your Social Security benefits to calculate your plan benefit. This is intended to offset the fact that Social Security replaces more of lower wage workers' salaries than of higher wage workers. Read your retirement plan's summary description to see if your benefits are integrated with Social Security.

Government Pensions: If you are eligible for a pension from a government job where you did not pay into Social Security, your Social Security benefits may be reduced. This applies to benefits based on your work record or on your spouse's work. For details, get *Government Pension Offset* (SSA Publication #05-10007) and *Windfall Elimination Provision* (#05-10045) from the Social Security Administration (ssa.gov).

Distributions after Death of the Account Owner

How the balance of your retirement account is distributed after your death depends on who you named as beneficiary, whether you had reached the required beginning date for distributions before your date of death, and the specific rules of the retirement plan or IRA custodian. Some custodians do not offer all the options allowed by the IRS. They may also dictate which option is the default if you fail to make an election.

Distributions from a Roth IRA after the death of the owner are calculated the same way as for a traditional IRA whose owner died before his required beginning date for distributions.

If you have annuitized and are receiving payments from that annuity, different rules apply. See **If you died while receiving annuitized payments from a retirement plan**, below.

Naming a beneficiary

You can (and should) name both primary and secondary beneficiaries for your account. You can change beneficiaries at any time, even after you are taking required minimum distributions.

Current tax law allows Designated Beneficiaryies (to be determined as late as September 30 of the year following the year of your death. This permits a beneficiary to be removed after your death. For example, a beneficiary could disclaim (refuse) the account or be cashed out.

When your beneficiary spouse survives you

A spouse has the option of rolling over the balance of a retirement plan to a Spousal Rollover IRA in her own name or leaving the account in the name of the deceased. For IRAs, the spouse can simply treat the IRA as her own if she is the sole beneficiary. Any required minimum distribution that the deceased spouse had not taken in the year of death must first be paid out. If the spouse is one of a group of beneficiaries for an IRA, she still has these options if a separate account is created for each beneficiary.

The right to have the IRA in her own name has several advantages. If she is not yet 70½, she can delay taking any distributions until then. She can also name her own beneficiaries. To calculate required distributions, she will use her own age and the Uniform Lifetime Table to calculate her distributions, just as the original account owner did. Since this life expectancy table assumes a spouse 10 years younger, she can take smaller required minimum distributions than could a non-spouse beneficiary who must use his single life expectancy.

If your spouse does not treat the IRA as her own or roll over the retirement account into a Spousal Rollover IRA, the required distributions depend on whether you had reached the required beginning date for your own distributions before your death.

- If you die *before* the required beginning date for your distributions, your spouse must begin taking distributions by December 31 of the year following the year in which you died, or by December 31 of the year in which you would have reached age 70½, whichever is later. The distributions are determined by recalculating your spouse's single life expectancy each year. Your spouse may elect to use the five-year rule, which requires that the total amount must be distributed by December 31 of the fifth year following your death; no distributions would be required until the final year. If she fails to begin taking distributions as required by the normal rule, she may be forced to distribute the entire balance within five years.
- If you die *on or after* the Required Beginning Date for your distributions, your spouse must take distributions each year based on her single life expectancy your remaining fixed life expectancy, whichever is longer.

Example: Rosa's husband dies, leaving her as the sole beneficiary of a large IRA account. He was 72 years old, so he had begun taking his Required Minimum Distributions. Rosa is only 64 and is still working. She doesn't need the money from the IRA yet. If she doesn't treat the IRA as her own, she will have to take a distribution every year. She decides to treat the IRA as her own, so that she can delay taking distributions until she is 70½.

When the beneficiary is not your spouse.

The distribution rules for a beneficiary who is not your spouse depend on whether you reached the required beginning date for your own distributions before your death.

- If you die *before* the required beginning date for your distributions, an IRA account will be distributed over the single, fixed life expectancy of your beneficiary, with distributions beginning by December 31 of the year following death. If there is more than one beneficiary, the life expectancy of the oldest is used unless separate accounts are established, allowing each beneficiary to use his own life expectancy. Your beneficiary may elect (or be required, if he fails to begin taking distributions by Dec. 31 of the year following death) to use the five-year rule.

  The choice is the same for employer retirement plans—to either use the life expectancy of the beneficiary or the five-year rule—unless the plan dictates that only one option is available.

- If you die *on or after* the required beginning date for your distributions, your beneficiary takes distributions using his own single, fixed life expectancy, or your remaining single, fixed life expectancy, whichever is longer.

A non-spouse beneficiary of an IRA or an employer retirement plan can have the account transferred directly to a new IRA custodian provided the new account is titled in the name of the deceased, for the benefit of the beneficiary.

When you have no named beneficiary, or your beneficiary isn't an Individual

Charities, your estate, and most trusts are not qualified beneficiaries because they aren't living individuals and don't have a life expectancy.

- If you die *before* the required beginning date for your distributions, the entire account must be distributed by Dec. 31 of the fifth year following the year of your death.
- If you die *on or after* the required beginning date for your distributions, required distributions will be calculated using your single, fixed life expectancy—after the required minimum distribution for the year of death has been withdrawn.

When you have multiple beneficiaries

Distributions will be made according to the life expectancy of the oldest beneficiary. However, distributions will be made as if there were no qualifying beneficiaries if any of them is a charity, your estate, or a trust that doesn't qualify.

Alternatively, separate accounts can be established for each beneficiary. The rules for each individual account will be determined based on the beneficiary of that particular account, as described above.

If you die while receiving annuitized payments from a retirement plan

- If you chose a single life annuity no further benefits are payable at your death. If you were married when you chose this option and the plan is an employer plan, your spouse must have signed a written waiver of her right to a survivor's annuity.
- If you chose an annuity with "period certain" and die before the period has ended, payments will be made to your spouse or beneficiary for the remaining time period.
- If you chose a joint annuity and you died first, your survivor will receive the selected amount until her death. Typically, the spouse's payment is a percentage of the payment received during the owner's lifetime.

Taxes on distributions at death

Income taxes: Your estate or beneficiary will owe income taxes on any benefits for which you would have owed income taxes. The funds will be taxed as they are distributed, which will usually be over a number of years. For example, if a beneficiary's life expectancy is 40 years, they could stretch those distributions and the taxes out over 40 years.

Estate taxes: Unless the total of your individual estate—including your retirement plans—and any taxable gifts you have made in your lifetime is more than the exclusion allowance equivalent, your estate will owe no federal estate tax. The exclusion allowance equivalent is $5,250,000 for 2013 and is indexed for inflation each year.

Generation skipping transfer (GST) tax: If you transfer more than the exclusion allowance amount to heirs two or more generations removed from you, such as grandchildren or great grandchildren, the amount over the exclusion allowance will be subject to the GST.

The exclusion amount for the GST is generally the same as for estate tax.

Example: Jerry died, leaving the balance of his IRA to his two children, Susan and Jack. The IRA is only $4,000, so they decide to take the money out rather than bother with annual distributions. Do they owe estate or income tax on the $4,000?

Jerry's estate – not the children – will owe estate tax on the $4,000 if his taxable estate is over the exclusion amount for the year he died. Each child will owe income tax on any distribution he/she receives. For example, if $2000 is paid to Susan and she's in the 28% tax bracket, she'll owe $560 in income taxes ($2,000 x .28).

Planning Tips

- Name both primary and secondary beneficiaries on all your retirement and IRA accounts. Review them every couple of years to make sure they still match your family and financial situation. Get professional advice before naming any beneficiary that is not an individual, such as your estate or a charity.
- If you are charitably inclined, consider naming a charity as a beneficiary of your retirement account rather than leaving the charity a non-retirement asset. The charity can avoid income taxes on retirement plan distributions, but your "human" heirs cannot.
- Know the rules about penalties and taxes, so you can avoid unnecessary ones.
- Check the rules of your employer's plan to see what distribution options you will have. Individual employer's plans may have more restrictive rules for distributions than the law allows. Must you withdraw funds in a lump sum if you leave the employer before retirement age? What payment options are offered at retirement? What payment options will your beneficiaries have? If plan rules are restrictive, consider rolling the money into an IRA that gives you and your beneficiaries more choices. Consult a professional if you need help in making the wisest choice.
- Warnings that the value of your retirement accounts will be greatly reduced by estate taxes, generation-skipping transfer (GST) taxes, and income taxes are valid *only* if all those taxes apply to you. GST only affects transfers to heirs two or more generations removed from you. Estate tax and GST apply only if the amounts are over the exclusion amount listed above under **Taxes on Distributions at Death**. If your estate will be smaller than these amounts, income tax may be your only concern.
- Distribution planning is very technical. Plan with caution, ask questions, and check with your tax advisor or Certified Financial Planner™ for guidance.

For more information about retirement issues, visit our blog at www.RetireWell.illinois.edu.

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