



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 IRAs contributions are not tax-deferred but earnings are tax-exempt, and different rules apply; see 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 always 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 are often subject 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, 2008 and reach 70½ on Jan. 4, 2009. Her first required distribution is for 2009. She must take it by April 1 of the following year—April 1, 2010. She must take her next distribution—for 2010—by December 31, 2010.

Eve turned 70 on May 30, 2004, and was 70½ on Nov. 30, 2004. She chose to take her 2004 distribution in October, 2004 even though the deadline was April 1, 2005. She took her second distribution—for 2005—in December, 2005.

Cate will owe income tax for two distributions on her 2010 taxes, which could put her in a higher tax bracket. Eve paid tax on one distribution in 2004 and one in 2005.

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__

<i>Reason for Distribution</i>	<i>Type of Retirement Plan</i>	
	<ul style="list-style-type: none"> ▪ Traditional IRAs ▪ SEP IRAs ▪ SIMPLE IRAs ▪ Roth IRAs 	<ul style="list-style-type: none"> ▪ 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

Different Rules for Roth Accounts: Roth IRAs and Designated Roth 401(k) and 403(b) Accounts

Contributions to Roth accounts are not taxed, whenever distributed, and *qualified* distributions of earnings are not subject to tax or penalty. Distributions from Roth IRAs are treated as coming first from contributions, while distributions from designated Roth accounts are allocated between contributions and earnings.

Qualified distributions are defined as:

- 1) occurring after at least five years of participation in the account, and
- 2) being made
 - after age 59½,

- due to owner's death or disability, or
- for Roth IRAs only, for qualified first-time home buyer expenses, up to a lifetime maximum of \$10,000.

Even if you owe tax on a distribution of earnings from a Roth IRA, you may be able to avoid the 10% penalty if one of the exceptions in Table 2 applies. Exceptions for designated Roth accounts were not available at the time of this writing.

Designated Roth 401(k) and 403(b) accounts are subject to the standard required minimum distribution rules explained later in this document. In contrast, 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. 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 transfers from one IRA to another, or **direct rollovers** from an employer retirement plan to an IRA or another retirement plan: If the money is transferred directly to a traditional IRA or your new retirement plan, there is no withholding and the tax-deferred status is preserved.

Indirect rollover: If the funds are paid to you rather than directly to the new IRA or retirement plan, 20% of the distribution must be withheld for income taxes. You have 60 days to roll the money into another IRA or employer plan to avoid taxes and penalties. If you roll over only the 80% that you actually receive, you will be taxed and perhaps assessed a penalty on the 20% that was withheld for taxes. 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 tax to seek a refund of the withheld amount. Plus, for indirect rollovers between two IRAs, you will not be able to make another rollover involving either of these

accounts for one year. If you are over age 70½, you cannot roll over your required minimum distribution for that year.

Conversions: You can convert money from a regular IRA into a Roth IRA unless you are married filing separately or your modified adjusted gross income is over \$100,000. (This income limitation will be removed in 2010.) You must roll the money into a Roth IRA within 60 days. You pay taxes on the amount converted, but no 10% early distribution penalty is owed. You can convert portions of a regular IRA in different years, to avoid having the entire amount taxed in one year. Beginning in 2008, you can also convert money directly from an employer retirement plan to a Roth. The transfer will be treated as a conversion if you meet the qualifications—tax filing status is not married filing separately and, until 2010, income is less than \$100,000.

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.

Example: Lil decides to move her IRA from the bank to a mutual fund company. She contacts the mutual fund company to set up the new account and fills out papers authorizing them to transfer the money from the bank to the new account.

Does the bank withhold taxes from the money transferred? No. It was a trustee-to-trustee transfer.

Example: Fred is changing jobs and 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 he set

up with his broker. 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 broker. The money that Fred deposits into the IRA within 60 days qualifies as a rollover. He can get a refund of the withholding when he files his taxes. But Fred's check will be for just \$8,000. If he only deposits \$8,000 into the IRA, he will owe taxes on the other \$2,000. He might also owe a 10% early distribution penalty if he is not yet 55. (Since he is separating from service, this is an exception to the usual 59½ age 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.

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.
- If you don't need the distributions from your IRA or retirement plan to cover expenses, you can convert to a Roth IRA and pay the taxes. (Until 2008, retirement plan monies must first be rolled over to a regular IRA and then converted to a Roth.) Qualified distributions from the Roth are tax-free (see p. 3). Roth IRAs have no required minimum

distributions for account owners, although there are required distributions for heirs.

- Know your rights to your spouse's retirement savings (and his/her rights to yours), so that you won't waive this important property right unless you've given it 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 and spread 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 an IRA and avoid the early distribution penalty. This strategy works for employer plans only if you no longer work there

Once you reach age 70½, you are required to take minimum annual distributions calculated by using a factor from the IRS Uniform Distribution Table. If your spouse is more than 10 years younger, you will use a different table that allows lower required distributions. Both tables are in IRS Publication 590. To determine the minimum distribution each year, you will divide the amount in your account at the end of the previous year by the Withdrawal Factor for your age as shown on 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.

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.

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 withdrawal, but you can take it all from one IRA or withdraw from several. You will also have to take minimum distributions from defined-contribution retirement plans such as profit sharing and 401(k) plans, and 403(b) plans.
- Consider your health, life expectancy (given your family history, health, etc.) and anticipated 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 even if you die first. If your plan doesn't offer this option, you might roll the balance to an IRA where you could annuitize it.

Annuitized payments are the automatic method of payment for defined benefit plans, unless you specifically make a different choice.

Defined benefit plans, some defined contribution plans, and 403(b) plans must offer annuities that provide survivorship benefits to spouses of plan participants. 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 an annuity is that you won't outlive your money (except for period certain annuities, which pay for a pre-determined number of years). However, annuities carry their own set of risks. You may die early and get very little of your investment back. Your spouse could die first, even after you have chosen a joint and survivor annuity with its smaller monthly payments. Also, inflation will reduce the value of your annual payments over time.

Do not confuse this method of taking your distributions with the *investment product* that is called an annuity. Annuities allow you to invest money for either fixed or variable returns and defer tax on those returns. You may buy an annuity directly from an insurance company. An annuity may also be one of your investment choices within your employer's retirement plan. Distributions from annuities do not necessarily have to be annuitized; lump-sum distributions or other choices may also be available.

Taxation of annuities: Under retirement plan annuities, the full amount of each payment will be taxable upon distribution if you bought the annuity with pre-tax dollars. For annuities bought outside a retirement plan, a formula determines the portion of each annuity payment that is taxable, based on your investment in the annuity.

Planning Tips

- If your annuity payment does not increase with inflation, an income that seems generous in the beginning will buy less and less as the years pass.
- Choosing an annuity as the investment within a tax-deferred plan offers no additional benefit and will have additional costs compared to mutual funds. When you are

ready to retire, you might choose to annuitize the mutual fund investments to give you a guaranteed stream of income.

Social Security and Distributions from Employer Retirement Plans

Integration with Social Security: Some employer plans subtract part of your Social Security benefits when calculating 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 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.

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, or they may dictate which ones are the default if you fail to make an election.

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.

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

Naming a beneficiary

You can (and should) name both primary and secondary beneficiaries for your account. Current tax law allows the Designated Beneficiary(ies) to be determined as late as September 30 of the year following the year of your death. This permits:

- you to change Designated Beneficiaries after the required beginning date for required minimum annual distributions.
- a Beneficiary to be removed after your death. For example, a beneficiary could disclaim (refuse) the account or be cashed out.

In addition, beneficiaries now have the option to spread distributions over a number of years. Under rules in effect prior to 2002, certain choices made by the account owner could force the entire account to be paid out in the year following the year of death.

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 his/her own name. For IRAs, the spouse can simply treat the IRA as his/her own if s/he is the sole beneficiary. Any Required Minimum Distribution which the deceased spouse had not taken in the year of death must first be paid out. Even if the spouse is just one of a group of beneficiaries for an IRA, s/he has this option if a separate account is created for each beneficiary.

Using this special right as a spouse has several advantages. To calculate required distributions, the spouse uses his/her own age and the Uniform Distribution Table, just as the original

account owner did. Since this life expectancy table assumes a spouse 10 years younger, s/he can take smaller required minimum distributions than could a non-spouse beneficiary who must use his or her single life expectancy. If the spouse is not yet 70½, s/he can delay taking any distributions until then. S/he can also name his/her own beneficiaries.

If your spouse does not treat the IRA as his or 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 would be determined by recalculating your spouse's single life expectancy each year. Or, your spouse may elect to use the five-year rule. Then, the total must be withdrawn by December 31 of the fifth year following your death.
- If you die *on or after* the Required Beginning Date for your distributions, your spouse must take distributions based on his/her single life expectancy each year. Or, s/he could use your remaining fixed life expectancy.

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. Or, your beneficiary can elect to use the five-year rule. 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/her own life expectancy.

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 individual 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/her own single, fixed life expectancy, or your single, fixed life expectancy, whichever is longer.

A non-spouse beneficiary of an IRA or, beginning in 2007 if the plan allows it, employer retirement plans can roll the account directly to a new IRA custodian provided the 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. No distributions are required until the final year.

- 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 (your spouse must have signed a written waiver of rights to a survivor's annuity for most employer plans), no further benefits are payable at your death.
- If you chose an annuity with period certain and die before the "period certain" has ended, payments will be made for the remaining guaranteed time period to your spouse or other beneficiary.
- If you chose a joint annuity and you died first, your survivor will receive the selected amount until his/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 \$2,000,000 in 2006-2008 and \$3,500,000 in 2009, with estate tax repeal in 2010. The law repealing the estate tax will expire at the end of 2010. Estate tax will apply to estates of \$1,000,000 or more beginning in 2011, unless Congress takes additional action.

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 the same as for estate tax until 2011, when the GST exclusion amount of \$1,000,000 will be indexed with inflation.

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?

Each child will owe income tax on the money he/she receives. If Susan received \$2,000 and she's in the 28% tax bracket, she'll owe \$560 in income taxes (\$2,000 x .28). Jerry's estate will owe estate tax on the \$4,000 if his taxable

estate is over the exemption amount for the year he died.

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, since these selections may limit the choices in how distributions can be made after your death.
- If you are charitably inclined, consider leaving a portion of the retirement account to charity rather than another asset. This will avoid income tax on the distribution as the charity is tax-exempt.
- Check the rules of your employer's plan to see what distribution options you will have. Employer plans may have more restrictive rules, especially for beneficiaries, than what 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? Will your beneficiaries be forced to withdraw all the money in the first year? If plan rules are restrictive, consider rolling the money into an IRA that gives more choices. Beneficiaries can also roll the money into an IRA after your death. Consult a professional if you need help in making the wisest choice.

- “Warnings” that your retirement accounts will be hit by estate taxes, generation-skipping transfer (GST) taxes, and income taxes, leaving little for your heirs, are valid *only* if their assumptions apply to you. GST only affects transfers to heirs two or more generations removed from you. Estate tax and GST apply only if your taxable estate (or, for GST, amount transferred) is over the exclusion amount listed under **Taxes on Distributions at Death**, above. If your estate will be less 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.

This fact sheet is available on the web at
<http://www.ace.uiuc.edu/cfe/retirement/>

For more on retirement issues, visit our interactive site,
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