California RETIREMENT Advisors

Personal Wealth Management For Retirement

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How Much Are Taxes on an IRA Withdrawal?

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How much you will pay in taxes on an individual retirement account (IRA) withdrawal depends on the type of IRA, your age, and the purpose of the withdrawal. Sometimes the answer is zero—you owe no taxes. In other cases, you owe income tax on the money you withdraw and sometimes an additional penalty if you withdraw funds before age 59½. On the other hand, after a certain age, you may be required to withdraw money and pay taxes on it.

There are a number of IRA options and a variety of places to get these account types, but the Roth IRA and the traditional IRA are by far the most widely held types. The withdrawal rules for other types of IRAs are similar to the traditional IRA, with some minor unique differences. Other types of IRAs are the SEP-IRA, Simple IRA or SARSEP IRA. Each type has different rules about who can open one.

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Tax-free Withdrawals: Roth IRAs Only

When you invest using a Roth IRA, you deposit the money after it has already been taxed. When you withdraw the money in retirement, you pay no tax on the money you withdraw—or on any gains your investments earned—a significant benefit. To take advantage of this tax-free withdrawal, the money must have been deposited in the IRA and held for at least five years and you must be at least 59½ years old. The other term for an IRA withdrawal is *distribution*.

Key Takeaways

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- Only Roth IRAs offer tax-free withdrawals
- If you withdraw money before age 59½, you will be assessed a 10% penalty in *addition* to regular income tax—unless you fit one of the tax exceptions or are withdrawing Roth contributions (not earnings).
- If your IRA is not a Roth, you will be taxed on withdrawals at your regular income tax rate for that year.
- At age 70½, you are required to withdraw money from every type of IRA but a Roth--whether you need it or not—and pay income taxes on it.

If you need the money before that time, you can take out your contributions with no tax penalty so long as you don't touch any of the investment gains. Keep a careful log of the money withdrawn prior to age 59½, and tell the trustee to use only contributions if withdrawing funds early. If you do not do this, you could be charged the same early withdrawal penalties charged for taking money out of a traditional IRA.

However, "for a retired investor who has a 401(k), a little-known technique can allow for a no-strings-attached withdrawal of a Roth IRA at age 55 without the 10% penalty," says James B. Twining of Bellingham, Washington. "The Roth IRA is 'reverse rolled' into the 401(k) and then withdrawn under the age 55 exception."

Knowing you can withdraw money penalty-free might give you the confidence to invest more in a Roth than you'd otherwise feel comfortable doing. If you really want to have enough for retirement, it is, of course, best to avoid withdrawing money early so that it can continue to grow in your account tax free.

When IRA Withdrawals Are Taxed

Money deposited in a traditional IRA is treated differently from money in a Roth. This is because you deposit pre-tax income—each dollar you deposit reduces your taxable income by that amount. When you withdraw the money, both the initial investment and the gains it earned are taxed at your income tax rate in the year you withdraw it.

However, if you withdraw money before you reach age 59½, you will be assessed a 10% penalty *in addition* to regular income tax based on your tax bracket. There are some exceptions to this penalty (see below). If you accidentally withdraw investment earnings rather than only contributions from a Roth IRA before you are 59½, you can also owe a 10% penalty. It is crucial to keep careful records.

Ways to Avoid the Early Withdrawal Tax Penalty

There are some hardship exceptions to penalty charges for withdrawing money from a traditional IRA or the investment-earnings portion of a Roth IRA before you reach age 59½. Some common exceptions for you or your estate include:

- Required distribution as part of a domestic relations order (divorce)
- Qualified education expenses
- Qualified first-time home purchase
- Total and permanent disability of the IRA owner
- Death of the IRA owner
- An IRA's levy on the plan
- Unreimbursed medical expenses
- A call to duty of a military reservist

One other way to escape the tax penalty: If you make an IRA deposit and change your mind by the extended due date of that year's tax return, you can withdraw it without owing the penalty. Of course, that cash will then be added to the year's taxable income.

The other time you risk a tax penalty for early withdrawal is when you are rolling over the money from one IRA into another qualified IRA. The safest way to accomplish this goal is to work with your IRA trustee to arrange a trustee-to-trustee transfer, also called a direct transfer. If you make a mistake trying to roll over the money without the help of a trustee, you could end up owing taxes. "Most plans allow you to put the name, address and your account number of the receiving institution on their rollover forms. That way, you never have to touch the money or run the risk of paying taxes on an accidental early distribution," says Kristi Sullivan, CFP® of Denver.

"In terms of IRA rollovers, you can only do one per year where you physically remove money from an IRA, receive the proceeds, and then within 60 days place the money into another IRA. If you do a second, it is fully taxable," says Morris Armstrong, a registered investment advisor in Cheshire, Connecticut.

You should not mix Roth IRA funds with the other types of IRAs. If you do, the Roth IRA funds will become taxable.

Regular Income Tax Only

Once you reach age 59½, you can withdraw money without a 10% penalty from any type of IRA. If it is a Roth IRA, you won't owe any income tax. If it's not, you will.

If the money is deposited in a traditional IRA, SEP IRA, Simple IRA or SARSEP IRA, you will owe taxes at your current tax rate on the amount you withdraw. For example, if you are in the 22% tax bracket, your withdrawal will be taxed at 22%. You won't owe any income tax as long as you leave your money in a non-Roth IRA until you reach another key age milestone.

Required Minimum Distributions

Once you reach age 70½, you will be required to take a minimum distribution from a traditional IRA. The IRS has very specific rules about how much you must withdraw each year. This is called the required minimum distribution (RMD). If you fail to withdraw the required amount, you could be charged a 50% tax on the amount not distributed as required.

You can avoid the RMD completely if you have a Roth IRA. There are no RMD requirements for your Roth IRA, but if money remains after your death, your beneficiaries may have to pay taxes. There are several different ways your beneficiaries can withdraw the funds, and they should seek advice from a financial advisor or the Roth trustee.

The Bottom Line

The money you deposit in an IRA should be money you plan to set aside for retirement, but sometimes unexpected circumstances get in the way. If you are considering withdrawing money prior to retirement, learn the rules regarding an IRA penalty and try to avoid that extra 10% payment to the IRS. If you think you may need emergency funds before retirement, use a Roth IRA for those funds rather than a traditional IRA.