Roth IRA Distribution:Tax and Penalty

Quick Reference Guide

Use this guide to determine if a distribution from a Roth IRA is subject to federal income tax and/or the 10% early distribution penalty.

How to Determine If Your Roth IRA Distribution is Subject to Income Tax and/or the 10% Penalty

	Source of Distributed Assets	Is Distribution Qualified *		Comments
		No	Yes	
Your distributions come from this source first	▪ Regular Roth IRA contributions & ▪ Rollovers from a Roth 401(k) or Roth 403(b), where the rollover amount is basis, i.e. from (a) a qualified distribution or (b) if the distribution is non-qualified, the amount is atributed to contributions(not earnings)	▪ Tax Free ▪ Penalty Free	▪ Tax Free ▪ Penalty Free	▪ Since (a) no deduction was ever received for your regular Roth IRA contributions, and (b) a rollover of basis from a Roth 401(k)/Roth 403(b) was already a 'qualified distribution' or represents Roth 401(k) or Roth 403(b) contributions; then distributions of these amounts are tax and penalty free regardless of how soon they are withdrawn.
Your distributions come from this source second on a First in first out (FIFO) basis. You never get to this source unless the first source has been depleted	▪ Taxable Conversions from Traditional, SEP and SIMPLE IRAs & ▪ Taxable Rollover from qualified plan, 403(b), 403(a) and 457(b)- *not including Roth 401(k) and Roth 403(b)*	▪ Tax Free ▪ 10% penalty applies if no exception	▪ Tax Free ▪ Penalty Free	▪ If it has been at least five years since the conversion was done, the 10% penalty does not apply to the non-qualified distribution ▪ Taxes do not apply, since any taxable amount was taxed at the time the amount was converted or rolled over to the Roth IRA
	▪ Nontaxable Conversions from Traditional & SEP IRAs & ▪ Nontaxable Rollover from qualified plan, 403(b), 403(a) and 457(b)- *not including Roth 401(k) and Roth 403(b)*	▪ Tax Free ▪ Penalty Free	▪ Tax Free ▪ Penalty Free	▪ These amounts come from nondeductible contributions to Traditional IRAs and rollover of after-tax amounts from qualified plans and 403(b) accounts ▪ Since these amounts would not have been subject to the early distribution penalty if they were distributed from a Traditional IRA, they are not subject to the early distribution penalty when withdrawn from the Roth IRA, regardless of how soon they are withdrawn
Your distributions come from this source last	▪ Earnings on Roth IRA & ▪ Rollover of earnings from non-qualified distribution from a Roth 401(k) or Roth 403(b)	▪ Tax applies ▪ 10 % penalty applies if no exception	▪ Tax Free ▪ Penalty Free	▪ This includes rollover of earnings from a non-qualified distribution from a Roth 401(k)/Roth 403(b)

* ***Qualified Distribution defined:*** A qualified distribution is one that meets the following two requirements:

1. The distribution must occur at least five years after your first Roth IRA was funded, and
2. The distribution must occur:
   a) after your death,
   b) as a result of you being disabled,
   c) on or after the day that you reached age 59 ½ , or
   d) if the amount is used towards the acquisition of , construction or reconstruction of a first time home of an eligible individual . This is limited to $10,000 for your lifetime.

If you are eligible for a qualified distribution, then all of your Roth IRA distributions will be tax and penalty-free. As such, there is no need to keep track of the sources of funding for your Roth IRAs, since the only reason to do so is to determine if any amount of the distribution is subject to tax and/or the 10% early distribution penalty.

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Tax and Penalty Determination on Non-qualified Distribution from a Roth IRAs

If a distribution from a Roth IRA is not a qualified distribution, then the ordering rules must be applied to determine how much of the distribution is taxable and/or subject to the 10% early distribution penalty. Under the ordering rules, Roth IRA assets are distributed in the following order:

Order	Source of Funding	Comments
1st	▪ Regular Roth IRA contributions ▪ Rollover of <u>basis</u> from a Roth 401(k) or Roth 403(b)	▪ These amounts are always tax-free and penalty-free ▪ *Basis from a Roth IRA or Roth 403(b)* is from (a) a qualified distribution or (b) if the distribution is non-qualified, the amount is attributed to salary deferral contributions to the Roth IRA (not earnings).
2nd	▪ **Roth conversions from Traditional IRAs, SEP IRAs, and SIMPLE IRAs** ▪ **Rollover contributions from qualified plans, 403(b) accounts, 457(b) accounts, 403(a) annuities**	▪ **You never get to these amounts unless al[illegible] the amounts in the 1st category are distributed from all of your n[illegible]-inherited Roth IRAs** ▪ **These amounts are always tax-free, [illegible]cause [illegible] taxes owed were already paid at the point of conversi[illegible] [illegible]llover.** ▪ **If these amounts have been in your Ro[illegible] [illegible] for at leas[illegible] five years, they are penalty-free** ▪ **If these amounts have n[illegible] been in your Ro[illegible] [illegible]A f[illegible] at least five years, the 10 % penalty [illegible]lies, unless you qualif[illegible] [illegible]n exception.*** ▪ **Each conversion or rol[illegible] has its ow[illegible] fi[illegible]-year clock, and withdrawals can[illegible] [illegible] made [illegible] a conver[illegible]n done in a particular year, unless [illegible] conve[illegible] that [illegible]curre[illegible] prior years have been fully distrib[illegible] from th[illegible] Roth IRA. [illegible]xample: Distributions from conversi[illegible] that [illegible] in 2010 can[illegible]ot occur until conversions from 2009 [illegible] previous [illegible] have been fully distributed.** ▪ **[illegible] con[illegible] [illegible] ro[illegible] [illegible] a Roth [illegible]A includes pre-tax and after-tax [illegible] are distributed first. For instance, if a [illegible] includes $[illegible],000 pre-tax and $20,000 after-[illegible] [illegible],000. After that amount [illegible] d[illegible]pleted, distributions will then come from the remaining [illegible],000.**
3rd	▪ Earnings that accrue within the Roth IRA ▪ The earnings amount for a rollover of a nonqualified distribution from a Roth 401(k) or a Roth 403(b).	▪ You never get to these amounts unless all of the amounts in the 2nd category are distributed from all of your non-inherited Roth IRAs ▪ These amounts are subject to income tax ▪ These amounts are subject to the 10% early distribution penalty unless you qualify for an exception.

***The exceptions to th[illegible] early d[illegible]ribution penalty:**
A distribution from a Roth IRA is neve[illegible] subject to the 10% early distribution penalty, if one of the following exceptions is satisfied at the time the distribution [illegible]curs:

▪ You are at least age 59 ½ ▪ You are deceased ▪ You are permanently disabled ▪ The distribution is part of a substantially equal periodic payment (SEPP) ▪ The amount is rolled over within 60-days of receipt	▪ The amount is used for medical expenses that are more than 7.5% of your adjusted gross income (AGI) ▪ The amount is not more than what it costs you for medical insurance ▪ The amount is used for qualified higher education expenses ▪ The distribution is from a conversion that has aged at least five years	▪ The amount is used buy, build or rebuild a first home ▪ The distribution is as a result of an IRS levy on the IRA ▪ The amount is a qualified reservist distribution ▪ The amount comes from regular contributions or nontaxable conversions/rollovers

Frequently Asked Questions

Q: I will be converting $100,000 from my traditional IRA to my Roth IRA. When will the income tax on the conversion be due?

A: It depends. Generally, the income tax due on your conversion amount must be paid by your tax filing due date. For instance, if you completed your conversion in 2009, the income tax payment due date would be April 15, 2010. However, an exception applies to Roth conversions from Traditional IRAs, SEP IRAs and SIMPLE IRAs; and Roth Rollovers from employer plans such as qualified plans, 403(b) plans, and eligible governmental 457(b) plans, that occur in 2010. Under this exception, you have two options for paying the income tax due:

Assume that you convert $100,000 in 2010. You have the following options for paying the income tax;

Option # 1: This is the Default Option	
• Add $50,000 to your income on your 2011 tax return. Pay the income tax due on the $50,000 by April 15, 2012.	• Add $50,000 to your income [illegible] your 2012 tax return. Pay the income tax due [illegible] the $50,000 by April 15, 2013.
Under this option, <u>none</u> of the amount is included on your 2010 tax return	

Option # 2: To choose this option, you must 'elect' to do so, when filing your tax return
• Add $100,000 to your income on your 2010 tax return. Pay the income tax due [illegible] $100,000 [illegible] April 15, 2011
Under this option, the entire amount is included on your 2010 tax return

Q: Who is responsible for determining if my Roth IRA distribution is a 'qualified distribution' and if it is not, the source of the distributed funds based on the ordering rules?

A: You, as the Roth IRA owner, are responsible for making that [illegible]. It may [illegible] idea to maintain a database or some form of records to keep track of your source [illegible], [illegible] you are [illegible] for a qualified distribution.

Q: My aunt died and left her Roth IRA to me and my four cousins. She had her Roth IRA for less than five years, and we know that distribution [illegible] to earnings will be taxable if [illegible] before the five year period. How do we share [illegible] responsib[illegible] for p[illegible] the [illegible]?

A: Each of you should rece[illegible] of [illegible], [illegible] received 1/5[th] of the Roth IRA, you will pay taxes on 1/5[th] of the [illegible] the five year period. Bear in mind that you will never get to the earning[illegible] from your inherited Roth IRA. *Note that if you have Roth IRAs that you estab[illegible] on your own, the five year period for your own Roth IRAs and the five year period for your beneficiary IRA [illegible] other . The five year period for your own Roth IRAs starts with the year that you fund your first Roth IRA [illegible] the [illegible] period for the Roth IRA that you inherit carries over from the decedent. For instance if [illegible] Aunt establishe[illegible] the Roth IRA that you inherited last year, the five year period for that IRA starts January 1 of last ye[illegible] establish you[illegible] Roth IRA next year, the five year period for your Roth IRA starts January 1 of next year.*

Q: I made my first contribution to my Roth IRA in June of last year, but I removed the contribution and the amount of earnings attributed to the contribution on April 15 of this year. In March 15 of this year, I made another contribution for this year, which will remain in the account. I do not have any other Roth IRAs. When does my five year period start for purposes of determining if my Roth IRA distribution is qualified.

A: Contributions th[illegible] yo[illegible] Roth IRA by your tax-filing deadline, plus extensions for the year for which the contribution was mad[illegible] for purposes of the five year rule. Therefore, your five-year period starts January 1 of this year.

Q: I had already met the requirements for a qualified distribution from my Roth 401(k) account. I established my first Roth IRA this year and rolled over the balance from my Roth 401(k) to my newly established Roth IRA. Does the five year period for my Roth 401(k) carry over to my Roth IRA?

A: No. The five year period for your Roth 401(k) is independent of the five year period for your Roth IRA. Therefore, since your first Roth IRA was funded this year, your five year period for determining if a distribution from any of your Roth IRAs is qualified starts January 1 of this year.

Q: I made a contribution to my Roth IRA on April 15 of this year, but it was made for last year. I also converted $50,000 to the same Roth IRA this year. How does this affect the five-year period?

A: For purposes of determining if your Roth IRA distribution is a qualified distribution, the five year period starts January 1 of last year, because that is the first year <u>for</u> which a Roth contribution or conversion occurred in any of your Roth IRAs. If your distribution is not qualified, and you need to withdraw amounts from your Roth conversions (which can occur only if you have already withdrawn all of your contributions), the five year period for that conversion starts January 1 of this year.

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Q: I had a balance of $100,000 in my Traditional IRA of which $20,000 was attributed to nondeductible Traditional IRA contributions. I converted $20,000 from my Traditional IRA to my Roth IRA earlier this year. Can I treat the entire conversion as nontaxable? If not, how does that affect distributions from my Roth IRA?

A: Whenever an individual has after-tax amounts in a Traditional IRA, any conversion from that Traditional IRA will include a pro-rated amount of pre-tax and after-tax assets. This rule applies even if you had the nontaxable amounts in a separate IRA, as all of your Traditional IRAs, SEP IRAs and SIMPLE IRAs are treated as one IRA for this purpose. Using your figures, this means that your conversion of $20,000 includes a pre-tax amount of $16,000 and after-tax amount of $4,000. If you take distributions from your Roth IRA and the distribution includes conversion amounts (see page 2), your distribution will come from the pre-tax amount of $16,000 first and then from the after-tax amount of $4,000. If the distribution is nonqualified, and you do not qualify for an exception to the 10 % early distribution penalty, you will pay the penalty on any distribution amount from the $16,000.

Example: Assume that your Roth IRA includes the following amounts:

- $5,000 regular contribution + $20,000 conversion (prorated to include $16,000 taxable and $4,000 n[illegible]able from your Traditional IRA); where the conversion was done last year + $1,000 earnings
- **Scenario 1: You take a non-qualified distribution of $5,000 from your Roth IRA.**
    - This will be tax and penalty-free, because it is from your contributions, based on the [illegible]ing rules.
- **Scenario 2: You take a non-qualified distribution of $14,000 from your Roth IRA.**
    - $5,000 will be tax and penalty-free, because it is from your contributions, based on the or[illegible] rules.
    - $9,000 will be treated as coming from the $16,000 of the $20,000 that was taxed when the c[illegible]sion was [illegible] so it will be tax-free, but will be subject to the 10% early distribution penalty, unless [illegible] the distribution occ[illegible] yea[illegible] after the conversion occurred or (b) you qualify for one of the exceptions to the [illegible]lty.
- **Scenario 3: You take a non-qualified distribution of $25,000.**
    - $5,000 will be tax and penalty-free, because it is from your contributions, b[illegible] on the orderin[illegible] rules.
    - $16,000 is treated as having been taken from the taxable amo[illegible] $20,[illegible] that was con[illegible]ted, so it will be tax-free, but will be subject to the 10% early distribution penalty, unl[illegible] (a) [illegible]tribution [illegible] years after the conversion occurred or (b) you qualify for one of the exceptions to th[illegible]nalty.
    - $4,000 will be treated as having been taken from the nontax[illegible] portio[illegible] of the $20,0[illegible] that was converted, so it will be tax-free and penalty-free
- **Scenario 4: You take a non-qu[illegible]fied distribution of $26,00[illegible]**
    - $5,000 will be tax [illegible] penalty-free [illegible] based on [illegible] ordering rules.
    - $16,000 is treated [illegible] having bee[illegible] taken fro[illegible] the ta[illegible] amount o[illegible]000 th[illegible] was converted, so it will be tax-free, but will be subject to [illegible] distribution o[illegible] years after the conversion occurred or (b) yo[illegible] qualify [illegible]
    - $4,000 will be trea[illegible] converted, so it will be tax-free and penalty-free.
    - $1,000 will be treated as coming from the [illegible] subject to income tax. It will also be subject to the 10% early distribution penalty unless you qualify for on[illegible] the exc[illegible] to the penalty.

***Important:** Conversions of after-tax am[illegible] tax-free conv[illegible]. In order to ensure you do not pay taxes on the $4,000, you must file IRS Form 8606. Form 8606 helps yo[illegible] the non-tax[illegible] amount of the conversion, and lets the IRS know how much of the conversion is nontaxable. You must inclu[illegible] co[illegible] IRS Form 8606 when you file your tax return for the year that the conversion is done.*

Q: I rolled over a nonqualified distribution from my Roth 401(k) to my Roth IRA, which represented my entire Roth 401(k) balance. However, the amount had lost market value and was less than the total contributions I made over the years. How does this affect the ordering rules for my Roth IRA?

A: You are allowed to [illegible] your [illegible] from your Roth IRA. For instance, if your aggregate contributions to your Roth 401(k) was $50,000, but the account v[illegible]ue was $40,000 when you rolled over the account balance to your Roth IRA, you are allowed to treat up to $10,000 of [illegible]ur Roth IRA earnings as Roth IRA contributions for the purpose of the ordering rules. Keep a record of the [illegible] funding for your Roth IRA, and make note of the amount that should not be taxed or be subject to the 10 % penalty.

Your Roth IRA before the Rollover		Your Roth 401(k) Balance	
Contributions	$20,000	Contributions	$50,000
Conversions	$50,000	Earnings/losses	($10,000)
Earnings	$5,000	Amount rolled over to your Roth IRA	$40,000

Using these numbers, up to $10,000 of the earnings in your Roth IRA will be tax and penalty-free, regardless of whether the distribution is qualified or not.

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