Avoiding extra tax on withdrawals from your IRA

The rules governing the tax treatment of withdrawals from a traditional IRA are three-pronged: Generally, you must pay tax on any withdrawals that you make prior to reaching age 59 1/2 and face an additional 10% tax for what is referred to by the IRS as an "early distribution."

Between ages 59 1/2 and 70 1/2, the rule is that you pay ordinary income tax on the amount that you withdraw in the year that you withdraw it. That's it, pure and simple.

Finally, once you reach age 70 1/2, you must begin to make annual withdrawals. A major penalty looms: If you fail to withdraw the required amount, you pay a whopping 50% penalty on the difference between what you should have withdrawn and what you actually did withdraw.

Exceptions to the 10% tax

If you need to need to tap a traditional IRA, although you never can avoid paying ordinary income tax on your withdrawals, there are instances when you *can* avoid paying the additional 10% tax. Here they are in a nutshell:

Death. As long as your IRA still is in your name at your death, generally, when the beneficiary of your IRA makes withdrawals, he or she will not have to pay the 10% additional tax. However, if an IRA is inherited from a spouse who elects to treat it as his or her own IRA, distributions prior to age 59 1/2 will be subject to the additional tax.

Disability. You will not have to pay the additional tax if you are disabled. You will be considered disabled, according to the IRS, if "you can furnish proof that you cannot do any substantial gainful activity because of your physical or mental condition." A physician must determine that your condition can be expected to result in death or to be of "long, continued, and indefinite duration."

Unreimbursed medical expenses. The additional tax also is avoided when you make withdrawals to pay for "qualified unreimbursed medical expenses" greater than 7.5% of your adjusted gross income. (These are expenses that will meet the standards for deductibility on your income tax return.) Two points to keep in mind: The expenses may

be either yours, your spouse's or your dependents,' and you need not actually itemize your deductions on your tax return to qualify under this exception.

Health insurance premiums for the unemployed. No additional tax will be imposed for withdrawals to pay health insurance premiums for you, your spouse and your dependents as long as you have received unemployment compensation under a federal or state law for at least 12 consecutive weeks. The withdrawals must be received either during the year of the receipt of unemployment compensation or the following year and also must be received no later than 60 days after you have become reemployed. If you were self-employed before you stopped working, your IRA withdrawals won't be subject to the 10% tax, as long as you *would have* qualified for unemployment, but for the fact that you were self-employed.

Home-buying expenses. A withdrawal of up to $10,000 to pay the expenses of purchasing, building or reconstructing a first-time home will not be penalized. The qualified expenses here are those paid in connection with a "principal" residence. The funds must be used within 120 days of receipt.

Higher-education expenses. A withdrawal from an IRA that is used to pay certain education expenses of a beneficiary (yourself, your spouse or children and grandchildren of you or your spouse) who are at least 18 years of age may not be subject to the 10% additional tax. Qualified higher education expenses include tuition, books, supplies and equipment. Room and board expenses may also qualify as long as the beneficiary is at least a "half-time" student.

The "periodic payments" rules

Another way to avoid the imposition of the 10% early distribution tax is to arrange to receive your withdrawals as a series of "substantially equal periodic payments" over your life expectancy or the joint life expectancy of you and your IRA beneficiary. The withdrawals must be taken annually and continue for at least five years or until you reach age 59 1/2, whichever is the longer period.

There are three IRS-approved methods for satisfying this exception. Once you have chosen to take your withdrawals under one of the three methods, the rules do not accommodate any switch from one of the approved methods to another before the end of

the waiting period without the imposition of the additional 10% tax (except in the case of death or disability).

Unfortunately, the recent market declines have had a negative impact on IRA owners who have chosen two of the three approved methods. How? Two of the methods require that you receive a fixed amount each year. If the required withdrawals are large, in a time when many people are seeing significant drops in their IRA balances, the assets in their IRA may be depleted severely, if not wiped out altogether.

The IRS took note of that fact and issued a ruling that provides relief for IRA owners who selected one of those two "fixed-payment" methods. The IRS will permit you to make a one-time switch to the third method. Withdrawals made using this method are determined according to account balance and life expectancy rather than requiring annual withdrawals of a fixed amount.

A note on Roth IRAs

Because contributions to a Roth IRA are made with previously taxed dollars, withdrawals may be completely tax free. That rule holds fast for withdrawals of your contributions.

However, for tax-free withdrawals of the *earnings* from your Roth IRA investments (and to avoid the 10% additional tax), they must be "qualified distributions." For a withdrawal to be a qualified distribution, you must have owned the Roth IRA for five years or be at least age 59 1/2, whichever happens first. If you have owned the IRA for five years, but have not reached age 59 1/2, you may avoid both the ordinary income tax and the additional tax when you meet one of the exceptions from the imposition of the 10% tax described in the traditional IRA discussion above.

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