OPTIONS FOR TAKING MONEY OUT OF A ROTH

Explaining some of the intricacies of withdrawals.

Provided by Timothy C. Hucks, CEP, President, Rising Tide, Inc.

Sometimes people want to access Roth IRA funds for early retirement or other purposes. Maybe you're one of them. If you have ever thought about taking money out of a Roth IRA, be sure to consult your financial advisor first before you make a move … and keep the factors mentioned below in mind.

You can withdraw regular contributions tax-free, but not your earnings. This is a critical distinction, and many Roth IRA owners don't seem to know about it.

When you withdraw assets from a Roth, there is a set order in which contributions and earnings must be distributed - the IRS ordering rules for distributions.[1]

- The IRS regards the first layer of withdrawals from a Roth as **regular contributions** instead of earnings. So this layer is treated as coming from your annual after-tax contributions. Therefore, if you just withdraw this layer of money, there are no taxes or penalties involved. (You can do this at any time, whether you have held your Roth for 5 years or not.) Basically, the IRS is permitting you to remove a percentage of your account before the alarm sounds on the five-year clock (see below).[2,3]

- The next assets to be removed from the account, according to IRS rules, are the **conversion and rollover contributions to your Roth.** These are removed on a so-called "first in, first out" basis. For example, the amount of a contribution to your Roth resulting from a conversion made in 2002 would come out before the amount of a contribution to your Roth resulting from a conversion made in 2008. The taxable portion of the conversion/rollover contribution comes out first (the amount claimed as income), and then the non-taxable portion.(By the way, the IRS disregards Roth-to-Roth rollover contributions in these rules.[1])

- Finally, **earnings** accrued by the Roth IRA are distributed**.**

So in other words, merely withdrawing your regular contribution will not trigger tax. But if your Roth has realized earnings from contributions, the earnings will be subject to income tax if they are withdrawn.

Is your withdrawal a qualified distribution? Here's another important consideration. If you have owned your Roth IRA for less than 5 years and/or are younger than age 59½, you risk taking a nonqualified distribution if you withdraw money from it. You know what that means – a 10% penalty for early withdrawal in addition to taxes. (There are some exceptions to this outlined in IRS Publication 590, which is certainly worth reading.)[1]

If you have owned your Roth IRA for more than 5 years …

- You can make a qualified withdrawal of earnings.
- You can make a qualified withdrawal of taxable conversions (conversions made in separate tax years will have to meet separate 5-year tests).

You can withdraw nontaxable conversions to your Roth IRA at any time.[3]

Watch the 5-year clock. Yes, how is the 5-year period preceding a qualified distribution measured? The clock starts on January 1st of the tax year of your initial contribution, conversion or rollover to a Roth IRA. For example, let's say you opened up a Roth IRA account on January 1, 2007. On January 1, 2012, your Roth IRA will meet the five-year test.[1]

What if you have multiple Roths? Well, when it comes to distributions, the IRS has some aggregation rules for you. You will have to figure out the taxable amounts withdrawn, distributions and contributions using a little addition. You must …

- Add up all distributions made from all your Roth IRAs during the tax year.
- Add up all regular Roth IRA contributions made during the relevant tax year (including ones made after the close of the tax year, but before April 15 of the following year). Now add that total amount to the total undistributed regular contributions made in previous years.
- Add all conversion and rollover contributions made during the year together. To quote Publication 590: "For purposes of the ordering rules, in the case of any conversion or rollover in which the conversion or rollover distribution is made in 2008 and the conversion or rollover contribution is made in 2009, treat the conversion or rollover contribution as contributed before any other conversion or rollover contributions made in 2009."[1]

There are additional rules for recharacterized contributions that end up in a Roth IRA.

If all this makes you want to talk to a financial advisor or accountant, before you take money out of your Roth IRA … well, that is a wise step to take. Confer with the financial or tax advisor you know and trust.

Timothy C. Hucks, CEP, is a Certified Estate Planner, Registered Investment Advisor and President of Rising Tide, Inc. He may be reached at www.risingtideinc.com, 919-968-8675, or tim@risingtideinc.com. Securities offered through Capital Investment Group, Inc. Corporate Office: 17 Glenwood Avenue, Raleigh, NC 27603 • 919.831.2370. Member FINRA/SIPC.

These are the views of Peter Montoya Inc., not the named Representative nor Broker/Dealer, and should not be construed as investment advice. Neither the named Representative nor Broker/Dealer gives tax or legal advice. All information is believed to be from reliable sources; however, we make no representation as to its completeness or accuracy. The publisher is not engaged in rendering legal, accounting or other professional services. If other expert assistance is needed, the reader is advised to engage the services of a competent professional. Please consult your Financial Advisor for further information.

Citations.

[1] irs.gov/publications/p590/ch02.html#en_US_publink10006523 [12/4/09]
[2] investopedia.com/ask/answers/179.asp?viewed=1 [12/4/09]
[3] smartmoney.com/personal-finance/retirement/nine-frequently-asked-questions-about-iras-7950/ [1/21/09]