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TAX & WEALTH ADVISOR ALERT: IRA DISTRIBUTION: THE GOLDILOCKS RULE

Understanding the rules of IRA distributions is like taking a trip through our childhood. Remember Goldilocks and the three bears? Too hot, too cold, just right? IRA distributions work a sort of the same way.

Cannot Be Too Early

IRAs were created by Congress to be retirement savings vehicles. Because of that intent, Congress (through the tax code) penalizes distributions from IRAs that are "too early." Too early is generally when the account owner is younger than 59½. The consequence of taking distributions too early is that when the account owner receives the distributions from the IRA, not only will the distributions be taxed at ordinary income rates, an additional 10% penalty will apply. There are some exceptions to the 10% penalty; most of which the account owner cannot plan for (death, disability) and others which are really not all that helpful (substantially equal payments over the owner's life expectancy).

Cannot Be Too Late

The power of the IRA is tax-deferred growth. The so-called Rule of 72 is supercharged when earnings can grow without the drag of income taxes. But always remember, when it comes to tax advantages, the government tends to see the taxes we save as its lost revenue. And it only delays receiving "its revenue" for so long. With IRAs, that time of reckoning comes on April 15 of the year after the year when the account holder reaches 70½. Thereafter, each year, the account holder must take what are known as required minimum distributions.

Cannot be Too Little

At 70½, account owners need to take required minimum distributions; any distributions that are less than that are penalized. Required minimum distributions are calculated based upon the life expectancy of the account owner. That life expectancy gets recalculated every year. The essence of recalculation is that even though the percentage of the account balance that must be distributed each year increases (due to the lessening of the account owner's life expectancy), it will never require the distribution of the entire account balance during the account holder's lifetime.

Cannot Go On Forever

While recalculation of life expectancy of the account owner means the IRA will never be depleted by required minimum distributions during the account owner's lifetime, the same cannot be said for periods after the death of that person.   If the IRA is left to the surviving spouse, the spouse also gets the benefit of annual recalculation. However, if the IRA is left to someone other than the surviving spouse, the best that beneficiary can hope for is the use of his or her life expectancy at the time of inheritance for the calculation of IRA distributions. That life expectancy will not be recalculated. So, for example, if an IRA is left to a child with a 30 year life expectancy, that child must receive 1/30th of the IRA the first year, 1/29th the second year and so on until the balance is distributed in the 30th year following inheritance. It is in that 30th year that the IRA will no longer be allowed to exist as a tax-free accumulation vehicle. (For more information on so-called stretch planning strategies for inherited IRAs, please see other articles on the website dedicated exclusively to this topic).

So when it comes to retirement, IRAs can be powerful planning tools. But like Goldilocks, there are a lot of restrictions in getting your clients' plans "just right."