Understanding Taxes Owed on Traditional IRA Withdrawals

If you own one or more traditional IRAs, you will probably take some withdrawals sooner or later. These withdrawals are "taxable," but what does that really mean?

Here's what you need to know about withdrawals and taxes.

Important: In the context of this article, "withdrawals" means garden-variety payouts from IRAs set up in your name as opposed to the required minimum distributions ("RMDs") that you must start taking after age 70 1/2. (RMDs are a whole different subject.)

Step 1: How Many Traditional IRAs Do You Have?

If you have several traditional IRAs, you must treat them as a single combined account to determine the tax consequences of withdrawals taken from any of them. For this purpose, don't forget to include any rollover IRAs established to receive distributions from any qualified retirement plans with former employers. Also include any simplified employee pension (SEP) accounts and SIMPLE-IRAs set up in your name. (Roth IRAs have different rules, and we will cover them in a future article.)

Key Point: If your spouse owns one or more traditional IRAs, it does not affect how withdrawals from your IRAs are taxed. In other words, the tax rules for IRA withdrawals are applied separately to your accounts and to your spouse's accounts.

Step 2: Determine Tax Results If You Have Only One Traditional IRA

There are two possibilities:

- You have not made any non-deductible contributions to your traditional IRA.
- You have made non-deductible contributions.

The tax results depend on which scenario applies.

Scenario A: **No Non-deductible Contributions.** In this case, all withdrawals are 100% taxable, and you must report them on your Form 1040 for the year they were taken. If you take withdrawals before age 59 1/2, they are hit with an additional 10% early withdrawal penalty tax unless you are eligible for an exception.

Scenario B: **Some Non-deductible Contributions.** Non-deductible contributions create tax basis in the account. Then each withdrawal includes some amount of basis. The basis amount is tax-free. The remainder is taxable. Taxable amounts are handled in the manner explained in the preceding paragraph.

To calculate tax-free basis amounts and taxable amounts, you must create a fraction. The numerator is your total non-deductible contributions to your traditional IRA as of the end of the year. The denominator is your traditional IRA balance on that date plus all withdrawals taken from the account during the year. Then, multiply your withdrawals by the fraction. The result is the amount of tax-free withdrawals of basis. The rest of your withdrawals are taxable.

Example 1: Over the years, you've made $12,000 in nondeductible contributions to your one traditional IRA.

During 2018, you withdrew $20,000. On December 31, 2018, the account is worth $60,000.

Your fraction is .15 [$12,000/($60,000 plus $20,000) equals 15]. Multiply your withdrawals by the fraction. The result is $3,000 ($20,000 times .15). That is the amount of tax-free basis included in your 2018 withdrawals. The remaining $17,000 ($20,000 minus $3,000) is taxable.

On your 2018 tax return, you enter the total withdrawals ($20,000) as well as the taxable withdrawals ($17,000). If you owe the 10% penalty tax, a separate IRS form must be filled out and the amount entered on Form 1040.

Step 3: Determine Results If You Have Several Traditional IRAs

Once again, it is possible that you have not made any non-deductible contributions to your traditional IRAs or you have made some. The tax results depend on which scenario applies.

Scenario A: **No Non-deductible Contributions.** Regardless of how many traditional IRAs you own, all withdrawals taken from any of the accounts are 100% taxable. The total withdrawals for the year must be reported on your Form 1040. If you take any withdrawals before age 59 1/2, they are hit with a 10% penalty tax unless you are eligible for an exception.

Scenario B: **Some Non-deductible Contributions.** To calculate tax-free basis amounts and taxable amounts, you must create a fraction. The numerator is your total non-deductible contributions to all your traditional IRAs as of the end of the year. The denominator is the combined balance of all your traditional IRAs on that date plus all withdrawals taken from those accounts during the year. Then, multiply your withdrawals by the fraction. The result is the amount of tax-free withdrawals of basis. The rest of your withdrawals are taxable.

Example 2: Over the years, you've made $18,000 in non-deductible contributions to two traditional IRAs: IRA-1 and IRA-2. You also own IRA-3, which is a rollover IRA that was funded with a distribution from a former employer's 401(k) plan. That account does not include any non-deductible contributions.

During 2018, you withdrew $28,000. For tax purposes, it doesn't matter which account (or accounts) the money came from. The tax results are the same.

On December 31, 2018, the three accounts are worth $272,000. Your fraction is .06 [$18,000/($272,000 plus $28,000) equals .06]. Multiply withdrawals by that fraction. The result is $1,680 ($28,000 times .06). That is the amount of tax-free basis included in your withdrawals. The remaining $26,320 ($28,000 minus $1,680) is taxable.

On your 2018 tax return, you enter $28,000 (total withdrawals) and $26,320 (taxable withdrawals).

If you owe the 10% penalty tax, a special IRS form must be filled out and filed with your Form 1040. The penalty amount is then entered on your return as additional tax due.

Step 4: Know the Tax Reporting and Filing Issues

Shortly after the end of each year that you take any withdrawals from a traditional IRA, you should receive a Form 1099-R from the IRA trustee or custodian. It will show the total amount of withdrawals for the preceding year. That is the amount you must report on your Form 1040 for that year. Otherwise, expect to hear from the IRS because it gets copies of all Forms 1099-R sent to you.

As explained earlier, the total amount of taxable withdrawals for the year must be reported on your Form 1040.

If you've made any non-deductible contributions, the calculations of tax-free and taxable amounts explained in this article are handled on an IRS Form 8606 that needs to be included with your return.

Key Point: IRS Form 8606 also needs to be filled out and included with your return for any year you make non-deductible traditional IRA contributions (whether or not you take withdrawals that year). By examining your prior-year Forms 8606, you can determine the cumulative amount of non-deductible contributions that you've made. You need to know that amount to determine the tax consequences when you take withdrawals. If you fail to keep track of your non-deductible contributions, you'll wind up paying taxes on amounts you should have treated as tax-free. Consult with your tax advisor for questions about your situation.

Rollovers from One IRA to Another

Distributions that you rollover to another IRA or qualified retirement plan are not subject to the additional 10% tax. You must complete the rollover within 60 days after the day you received the distribution.

The amount you roll over is generally taxed when the new plan makes a distribution to you (or your beneficiary).

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