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Penalty on withdrawals from Roth IRA?

By George Saenz • Bankrate.com

Dear Tax Talk,
I withdrew $38,000 from my Roth IRA last year due to unemployment to pay living expenses, medical premiums and bills. Is there a way to avoid paying an early withdrawal penalty?
-- Janet

Dear Janet,
Unlike traditional IRAs, distributions from Roth IRAs prior to age 59 ½ may escape the 10 percent penalty for early withdrawals. If you're over age 59 ½ there is no 10 percent penalty for traditional or most Roth IRA distributions (that have been in the account for five years). The penalty on early Roth withdrawals depends on how the money got in the IRA and how long it's been there.

Withdrawals have ordering rules to determine the character of the funds. A withdrawal is considered to consist of the following:

1. Regular Roth IRA contributions.
2. Taxable rollover conversions (on first-in, first-out basis).
3. Nontaxable rollover conversions.
4. Repeat of steps 2 and 3 for each conversion.
5. Earnings.

For example, if you contributed $25,000 to your Roth IRA and it earned $20,000, your $38,000 withdrawal would consist of $25,000 in regular contributions and $13,000 in earnings.

A withdrawal of your regular contributions is always tax and penalty-free even if you're under age 59½ or have had the account for less than five years. However, the earnings are taxable and subject to penalty.

If the Roth IRA consists of an IRA conversion or employer plan rollover that has been there at least five tax years, then there is no 10 percent penalty on the converted or rolled-over amounts. You count the five years from Jan. 1 of the year in which the conversion/rollover occurred. This means that for 2010 distributions, the conversion or rollover had to occur in 2005 or earlier. Don't pay the 10 percent penalty on the converted or rolled-over amounts, but earnings are subject to the penalty.

Traditional IRA and Roth IRA withdrawals used to pay medical insurance premiums under certain conditions are exempt from the 10 percent penalty.

You will not owe the 10 percent penalty to the extent your distributions during the year are not more than the amount you paid during the year for medical insurance for yourself, your spouse and your dependents. You will not have to pay the penalty on these amounts if all of the following conditions apply:

You lost your job.
You received unemployment compensation paid under any federal or state law for 12 consecutive weeks because you lost your job.
You receive the distributions during either the year you received the unemployment compensation or the following year.
You receive the distributions no later than 60 days after you have been reemployed.

Continuing the prior example, if you paid $6,000 in medical insurance, this would be considered to come out of your earnings withdrawal of $13,000 so that you would pay income tax on the $13,000 and a penalty on $7,000.

The Roth withdrawal distribution rules can be complex if your Roth consists of contributions, rollovers or conversions from various years. You can review IRS Publication 590 for more information, but I found it to be quite light on the topic.

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