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When Must Taxes Be Paid on IRA and Employer-Sponsored Retirement Funds?

Traditional IRAs and most employer-sponsored retirement plans are tax-deferred accounts, which means they are typically funded with pre-tax or tax-deductible dollars. As a result, taxes are not payable until funds are withdrawn, generally in retirement.

Withdrawals from tax-deferred accounts are subject to income tax at your current tax rate. In addition, taxable withdrawals taken prior to age 59½ may be subject to a 10% federal tax penalty (a number of exceptions from the penalty tax are available).

If you made nondeductible contributions to a traditional IRA, you have what is called a "cost basis" in the IRA. Your cost basis is the total of the nondeductible contributions to the IRA minus any previous withdrawals or distributions of nondeductible contributions. The recovery of this basis is not counted as taxable income.

Exceptions are the Roth IRA and the Roth 401(k), Roth 403(b), and Roth 457(b). Roth accounts are funded with after-tax dollars; thus, qualified distributions (after age 59½ and the five-year holding requirement has been met) are free of federal income tax. (Even if a distribution from your Roth account isn't qualified, you still receive your own Roth contributions back tax-free.) Roth IRAs do not impose required minimum distributions (RMDs) due to age. Through the end of 2023, Roth 401(k)s and other Roth employer-based accounts are subject to RMDs just like traditional accounts. However,

beginning in 2024, they will no longer be subject to RMDs. Although surviving spouses may be able to stretch RMDs of inherited retirement assets over their lifetimes, a tax rule that took effect in 2020 gives most non-spouse beneficiaries a maximum of 10 years to pull out all inherited funds.

Traditional IRAs, most employer-sponsored retirement plans, and Roth 401(k), 403(b) and 457(b) plans, are subject to annual required minimum distributions (RMDs) that must generally begin after you reach age 73 (for individuals who reach age 72 after December 31, 2022). The first RMD must be taken no later than April 1 of the year after the year in which you reach age 73. If you attained age 72 in 2022 or earlier, you are already required to take annual RMDs. Failure to take an RMD triggers a federal tax penalty of up to 25% on the amount that should have been withdrawn. Roth IRA owners never have to take RMDs; however, the designated beneficiaries of IRAs and employer-sponsored retirement plans do have to take RMDs.

When you begin taking distributions from your retirement accounts, make sure to pay attention to any required beginning dates and the appropriate distribution amount in order to avoid unnecessary penalties.

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