Are There Really Tax-Free Retirement Plan Distributions?

A look at some popular & obscure options for receiving money with little or no tax.

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Will you receive tax-free money in retirement? Some retirees do. You should know about some of your options for tax-free retirement distributions, some of which are less publicized than others.

Qualified distributions from Roth accounts are tax-free. If you own a Roth IRA or have a Roth retirement account at work, you can take a tax-free distribution from that IRA or workplace retirement plan once you are older than 59½ and have held the account for at least five tax years. One other nice perk: original owners of Roth IRAs never have to take Required Minimum Distributions (RMDs) during their lifetimes. (Owners of employer-sponsored Roth retirement accounts are required to take RMDs.)[1,2]

Trustee-to-trustee transfers of retirement plan money occur without being taxed. In a rollover of this kind, the custodian financial firm that hosts your workplace retirement plan account makes a payment directly out of the account to an IRA you have waiting, with not a penny in taxes levied or withheld. Trustee-to-trustee transfers of IRAs work the same way.[3]

If you are older than 80, you might get a tax break on a lump-sum withdrawal. If you were born prior to January 2, 1936, you could be entitled to a tax reduction on a lump-sum distribution out of a qualified retirement plan in certain cases. Unfortunately, this is never the case with an IRA RMD.[4]

Your heirs could receive tax-free dollars resulting from life insurance. Payouts on permanent life insurance policies are normally exempt from federal income tax. (The payout may be included in the value of your taxable estate, though.) A life insurance death benefit paid out from a qualified retirement plan is also tax-exempt provided the death benefit is greater than the policy's pre-death cash surrender value. Even if an employee takes a distribution from a corporate-owned life insurance policy on his or her life while still alive, that distribution may not be fully taxable as it may constitute a return of the principal invested in the life insurance contract.[4,5]

Sometimes the basis in a workplace retirement account can be withdrawn tax-free. If you have made non-deductible contributions through the years to an IRA or an employer-sponsored retirement plan account, these contributions are not taxable when they are distributed to the original account owner, accountholder, or an account beneficiary – it is considered return of principal, a recovery of the original account owner or accountholder's cost of investment.[4]

IRA contributions can optionally be withdrawn tax-free before their due date. As an example, your 2016 IRA contribution can be withdrawn tax-free by the due date of your federal tax return – April 15 or thereabouts. If you file Form 4868, you have until October 15 (or thereabouts) to do this.[6]

Withdrawals such as these can only happen, however, if you meet two tests set forth by the IRS. First, you must not have taken a deduction for your contribution. Second, you must, additionally, withdraw any interest or income those invested dollars earned. You can also take investment losses into account. (There is a worksheet in IRS Publication 590 you can use to calculate applicable gains or losses.)[6]

These common and obscure paths toward tax-free retirement income may be worth exploring. Who knows? Perhaps, this year, your retirement will be less taxing than you think.

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Citations.

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