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Withdrawal Pains

Regardless of what type of retirement plan you have — whether a "qualified plan" through an employer, or IRA — at some point you will have to decide how the funds are to be distributed. Current tax rules governing transfers between accounts, withdrawals, and distributions are notoriously complex, and the penalties for not following them costly.

Congress established qualifying retirement plans and IRAs to increase overall savings as well as to provide Americans an incentive to supplement retirement income available from Social Security and private savings. The combination of tax-deductible contributions and tax-deferred compounding permits interest and dividends on invested funds to accumulate tax-free until they are withdrawn (and are then taxed as ordinary income). Since savings in such accounts will accumulate much faster than they would in a taxable account, these various sheltered accounts ostensibly provide strong incentives to save.

Congress cobbled together this retirement-savings system and its Byzantine rules, Draconian penalties, and assorted exceptions over many years. Thus, there are 403(b) plans for teachers and employees of nonprofits; 401(k) plans for businesses; 457s for state and local government employees; Keoghs and SEP-IRAs for the self-employed; IRAs for employees with no company plans or lower-income employees, and more.

Any policy that offers special reward to some people for a particular type of behavior (*i.e.*, saving) over time almost invariably promotes demand for additional rewards in the form of amendments, exceptions, and other new rules from others who may claim to be disadvantaged by the policy. In this sense, such policies provide ever greater opportunities for statist politicians to adhere to a politically correct agenda that requires them to "bash the rich" at the same time that they sell more "goodies" to any number of special interest groups.

In the current instance, they have sought to encourage individuals to save — but have discouraged the build up of tax-deferred treasure chests for individual or family legacies for "the rich." Hence, the jumble of penalties, exceptions, age limits, actuarial tables, and arbitrary specifications that apply to distributions (*e.g.*, "you must begin taking minimum required withdrawals by April 1 following the end of the year in which you turn 70½"). Additional restrictions are designed to ensure that relatively wealthy tax-payers do not benefit disproportionately from tax breaks; hence, income limits that determine the eligibility for tax-deductible contributions.

Special rewards, on the other hand, are available for behavior that follows a major political interest group's agenda — be it that of the education establishment, the healthcare lobby, or whatever. For example, when "first-time homebuyers" (*i.e.,* the realty and banking lobbies) objected that penalties for early withdrawals from sheltered accounts effectively prohibited them from contributing to such accounts — a new exception was legislated permitting first-time homebuyers to withdraw up to $10,000 without penalty. And so on. Eventually, such changes may proliferate to the point that the rules become confoundingly complex.

The penalties imposed for breaking the rules are directly related to lawmakers' arbitrary judgment concerning the severity of the behavior. (There is a 6 percent penalty on excess contributions, a 10 percent penalty for early withdrawal, and a 50 percent penalty on distribution shortfalls.) As noted, the exceptions to these penalties virtually always involve behavior the authorities view as "legitimate" to the needs of some constituency.

Avoiding Taxes and Penalties

The IRS reports that in 1996, over 3.4 million returns paid a total of more than $2.2 billion in penalty taxes associated with qualified retirement plans; up from 3.0 million returns, and $1.8 billion paid in 1995. It is not surprising that these penalties amount to billions of dollars; many people are not aware of what they must consider, or the taxes and penalties that lurk should they make a misstep. Moreover, many financial consultants are ill-equipped to provide adequate advice on such matters. They may find it expedient to advise you to do what's easiest for *them*. Most people would be well advised to familiarize themselves with the major rules governing the distribution of funds in the tax-sheltered accounts.

Fortunately, a new easy-to-read volume is now available for just that purpose — Twila Slesnick and John Suttle's *IRAs, 401(k)s & Other Retirement Plans: Taking Your Money Out*.[1] This book is filled with easy to find and understand answers for anyone:

- approaching retirement
- retiring early
- changing jobs
- dividing a plan at divorce
- wishing to consolidate retirement plans
- wanting to borrow money from their retirement plan
- wondering what to do with an inherited plan.

The book is conveniently organized and indexed, and provides many examples that guide the reader through calculations. It includes planning tips based on strategies that other people have used successfully and points out potential pitfalls that may result from taking, or failing to take, certain actions.

Taking Your Money Out describes the rules that apply to distributions from your retirement plan during your lifetime as well as the rules concerning distributions to your beneficiary if you die before age 70½ and distributions to your beneficiary if you die after age 70½. Roth IRAs, which differ in many aspects from most other qualified retirement plans, are dealt with

[1] *IRAs, 401(k)s & Other Retirement Plans: How to Take Your Money Out*, by Twila Slesnick and John C. Suttle, Berkeley, CA, Nolo Press, 1998, $21.95 soft cover. The discussion that follows is based on this volume.

in a separate chapter.

Slesnick and Suttle review the basic tax rules for maximizing *after-tax* wealth, which include three obvious but apparently often ignored rules of thumb: (1) defer the payment of tax; (2) pay tax at the lowest rate; and (3) avoid tax penalties.

By deferring the receipt of income, individuals have the use of funds that would otherwise have gone to taxes; and if those funds are invested, they will help generate more tax-deferred income. Although many low and middle-income taxpayers almost surely will benefit by doing so, deferring income may not be advantageous in all circumstances.

Indeed, it is precisely such circumstances that demand consideration of the second rule above: pay tax at the lowest rate. Most people will be in a lower tax bracket after retirement, but for those who expect to be in a permanently higher tax bracket in the future, deferring distributions could result in a higher tax bill and lower after-tax balances. For example, any long-term capital gains you earn outside an IRA will be taxed at the capital gains rate (currently 20 percent maximum). The same capital gains earned inside an IRA could face double that rate. Generally, if you hold assets that appreciate largely through capital growth, and if your withdrawals will begin sooner rather than later, the advantages of tax deferral may well disappear. Moreover, sheltered accounts do not allow write-offs of capital losses.

The authors' final caveat, to avoid tax penalties, again seems obvious — and may, as they suggest, be wise to observe at all times. They provide a variety of strategies for avoiding penalties, many of which include taking advantage of little-known exceptions. Individual financial circumstances vary enormously, however. For those whose taxable income fluctuates markedly from year to year, "swallowing" the 10 percent early distribution penalty may make tax sense in some situations: say, if taxable income in a given year is greatly reduced and the after-penalty, after-tax amounts from an early IRA distribution would be greater than could be obtained in subsequent years.

General Income Tax Rules for Retirement Plans

Some basic income tax rules apply to withdrawals from a retirement plan. Although these apply in most situations, the authors note that each rule has exceptions. A principle rule requires that distributions (after age 59½) are taxable at ordinary income tax rates. However, contributions may or may not have been tax-deductible. If some were not, then withdrawals may be partly tax-free. Keeping track of taxable earnings and nontaxable principle is a headache — IRS Publication 590 may be of help in keeping a record of yearly contributions and distributions.

Most employers' plans allow little control over distributions; they dictate which assets must be distributed. Many people are surprised to learn, on the other hand, that they are not required to take distributions in cash but can choose the assets that are to be withdrawn from an IRA. If you take stocks, bonds, or mutual funds, the amount of the distribution is the fair market value of the property.

You may not claim losses on your tax return from investments purchased inside your retirement plan with tax-deferred money. The authors say you shouldn't cry foul: the assets were purchased with pre-tax dollars, and any losses reduce your taxable distribution. On the other hand, any asset that appreciates through capital gains in effect is a tax shelter in its own right: taxes do not have to be paid until the asset is sold and any gain realized. As with sheltered assets, losses ultimately reduce the amounts accrued in a taxable account — but they can be written off outside a qualified plan. Why not in a qualified plan account?

The rules above apply whether you inherit a retirement plan or receive one in a divorce settlement. Put simply, the plan is treated as if you were the original owner.

Options for Paying Taxes at Retirement

If you receive a distribution at retirement you have three options: (1) report the distribution as ordinary income; (2) roll over the distribution into an IRA or other retirement plan; or (3) use a method of computing taxes called five- or ten-year averaging (if you qualify).

Anyone can take the distribution and pay ordinary taxes, and some do because it is the path of least resistance in dealing with the IRS. This gives you unrestricted use of your funds, because you are no longer subject to the rules of the plan. The biggest disadvantage to this approach, however, is that if the distribution is large, you could be pushed into a higher tax bracket.

A second option — regardless of your age — is to roll over the distribution into an IRA. This option is attractive if you don't need the funds immediately. Leaving money in an IRA allows it to grow tax-deferred and possibly allows you withdraw it in such a way as to remain in a lower tax bracket. If this option is elected the funds should be transferred via a "direct rollover" — *i.e.,* directly from your old employer's plan into the new IRA. Not all distributions are eligible for rollover. Ineligible distributions include after-tax contributions, distributions that are required because you have passed age 70½, and distributions in the form of a life annuity or periodic payments that last for ten years or more. Moreover, anyone contemplating a rollover should be aware of possible "traps": there are severe penalties for rolling over ineligible funds; and, once completed a rollover may not be undone.

Five- and ten-year averaging allow you to treat the distribution as if it were spread over a five- or ten year period. (Note that after 1999, five-year averaging will no longer be available.) Slesnick and Suttle recommend these methods for people who need funds, but don't want to give up as large a chunk of their nest egg to taxes as would be the case with taking the distribution as a lump-sum and paying ordinary taxes. Persons with large distributions will incur a substantial tax bite. Ten-year averaging works much the same way as five-year averaging, except it requires that the 1986 tax rates, not current ones, be used. The tax rates in 1986 were more progressive than they are currently — *i.e.*, the low rates then were lower than today's and the high rates then were higher than now. For this reason alone, five-year averaging of large distributions may be preferable to ten-year averaging.

Lump-sum distributions from qualified retirement plans, under certain circumstances, may qualify as capital gains and be taxed at 20 percent. Only the taxable amount of distributions resulting from pre-1974 participation qualifies for capital gains treatment. You can then use the five- or ten-year averaging methods or ordinary income tax rates to calculate taxes for the remaining portion of your distribution.

Tax-deferred annuities and IRAs have special tax rules. The rules governing withdrawals from tax-deferred annuities (TDAs) have more in common with qualified plans than IRAs. And Roth IRAs and traditional IRAs have as many differences as they do similarities. You can roll a TDA into another TDA or an IRA. Neither averaging nor capital gains treatment is allowed for TDAs or IRAs. Roth IRAs offer tax-free distributions if you have met certain requirements.

All retirement plans, with the exception of the Roth IRA, normally require that you take money out of your plan by April 1 of the year after you turn 70½ (Only if you continue to be employed beyond age 70½ may withdrawals be postponed under some plans and circumstances.) The *minimum* payout depends on your life expectancy or the joint life expectancy of you and a beneficiary. Roth IRAs do not require a minimum distribu-

How to Hurt Your Head While Thinking

To get an idea of how complicated the rules for getting your money out of an IRA are, consider the example of a fairly typical retiree:

Bob Taylor turns 70½ this year, thus he is required to begin taking annual distributions from his IRA by April 1, 2000. He has named his wife, Barbara, who is 68, as his designated beneficiary on each of his various IRA accounts. Using their ages on their birthdays in 1999, he uses IRS tables to calculate their joint life expectancy (these tables are included in *IRAs, 401(k)s and Other Retirement Plans: Taking Your Money Out*). The table indicates that their joint life expectancy is 21.5 years. On December 31, 1998, the total value of all Bob's IRA accounts was $300,000. Dividing $300,000 by 21.5, he finds that his required minimum distribution for 1999 is $13,953.

Bob must withdraw at least this amount (he could take more) between January 1, 1999 and April 1, 2000. He can do it in bits and pieces or a single withdrawal. He can take the funds from whichever IRA accounts he chooses; he does not have to draw down each account. (The rules are different if he named different beneficiaries on different accounts.) In deciding how to time his first required withdrawal, he keeps in mind that withdrawals taken in 2000 will be taxed as income that year, and that he will also have to take his second annual distribution by the end of 2000. If he postpones his first distribution until 2000, he will be taking two required distributions in one year, which could push him into a higher tax bracket.

By April 1 of 2000, Bob must also decide how to calculate his joint life expectancy in future years. The IRS permits two methods, each of which has pros and cons. If Bob doesn't specify which method he plans to use in the future, the IRS will assume he has chosen to recalculate his joint life expectancy every year. As the authors of *Taking Your Money Out* note, this is very often the wrong choice. Too bad, because once the choice is made, it is irrevocable.

As noted, Bob has multiple IRA accounts. He does not have to designate Barbara as the beneficiary of every account. He could name his children or grandchildren. This would increase his joint life expectancy, and thereby reduce Bob's required distributions and the tax due on them. However, Congress limits this loophole. Non-spouse beneficiaries who are more than 10 years younger than him are deemed, for purposes of calculating required distributions, to be *only* 10 years younger.

Suppose Bob names his wife as beneficiary on all the accounts, then he dies and she rolls over the remaining IRAs into a new account in her name, with her son as beneficiary? When will taxes be due, and how much? Or, suppose he names his children as beneficiaries and uses the "recalculation method" to figure distributions. What will happen to the funds upon his death — will they have to be distributed (and taxed) all at once, or can the kids continue to take annual payments for the rest of their lives? Suppose he wants to change beneficiaries after he starts taking required distributions? What if he wants to name a trust as the beneficiary? Can he do this and, if so, what are the tax implications? Would he be better off simply rolling over his traditional IRAs into a Roth IRA?

Unless Bob is a tax accountant, he would be well advised to read *Taking Your Money Out* for help answering these questions and many others he probably isn't aware he should be asking. The price of the book is a small investment given the wealth at stake.

Bob's head now hurts from thinking about his withdrawal problems, and, in order to avoid similar headaches in future years, he has decided to take the easy way out by electing *not* to recalculate his joint life expectancy each year. He also does not want to have to make two withdrawals in 2000, and so has elected to withdraw the required minimum at the end of the year in 1999 and thereafter. His annual minimum withdrawals, as well as remaining account balances, are shown at right according to several different yield assumptions.

Required minimum withdrawals from a $300,000 IRA

(For a male 70 years old in 1999, wife 68 years old, using joint life expectancy and assuming various investment returns)

		5%		*7%*		*9%*	
Year	*Husband's age*	*Required Minimum Withdrawal*	*Remaining Balance*	*Required Minimum Withdrawal*	*Remaining Balance*	*Required Minimum Withdrawal*	*Remaining Balance*
1999	70	$13,953	$286,047	$13,953	$286,047	$13,953	$286,047
2000	71	14,651	285,698	14,930	291,140	15,209	296,581
2001	72	15,384	284,599	15,975	295,544	16,578	306,696
2002	73	16,153	282,676	17,094	299,138	18,070	316,228
2003	74	16,961	279,849	18,290	301,788	19,696	324,992
2004	75	17,809	276,033	19,570	303,343	21,469	332,772
2005	76	18,699	271,136	20,940	303,636	23,401	339,320
2006	77	19,634	265,058	22,406	302,484	25,508	344,352
2007	78	20,616	257,696	23,975	299,684	27,803	347,540
2008	79	21,646	248,934	25,653	295,009	30,305	348,513
2009	80	22,729	238,652	27,449	288,211	33,033	346,846
2010	81	23,865	226,719	29,370	279,015	36,006	342,057
2011	82	25,058	212,997	31,426	267,120	39,246	333,595
2012	83	26,311	197,335	33,626	252,193	42,779	320,840
2013	84	27,627	179,575	35,980	233,867	46,629	303,087
2014	85	29,008	159,546	38,498	211,740	50,825	279,539
2015	86	30,459	137,064	41,193	185,368	55,400	249,298
2016	87	31,982	111,936	44,076	154,268	60,386	211,350
2017	88	33,581	83,952	47,162	117,905	65,820	164,551
2018	89	35,260	52,890	50,463	75,695	71,744	107,616
2019	90	37,023	18,511	53,996	26,998	78,201	39,101
2020	91	remaining balance	0	remaining balance	0	remaining balance	0

tion. The absence of such minimum-distribution rules greatly simplifies your tax and estate planning.

The penalty for failing to take the minimum required distribution, 50 percent of the shortfall, is punitive. Make sure you get this calculation right. If you make a mistake, you may petition the IRS for a waiver, which is generally granted. Your plan may be disqualified if the failure to take required distributions becomes chronic.

Options for Paying Taxes Before Retirement

You may receive a distribution from your retirement plan before you retire if you change jobs, your company terminates or changes its plan, or you wish to get the money out for one reason or another. Remember, the qualified plan rules are designed with penalties to get you to leave your money in some type of plan until retirement or use it for some purpose that authorities deem "appropriate."

The basic options for taking money out of a plan before retirement are the same as above. The key difference hinges on the age at which you receive the distribution. If you have reached age 59½, you can pay ordinary income tax, roll over your distribution, or use the five- or ten-year averaging method if you meet the requirements. There will be no penalties unless you try to rollover funds that are ineligible.

If you are changing jobs, you should use a direct rollover into a conduit IRA. Conduit IRAs allow you to transfer assets from one employer's plan to another employer's plan. Use a new and separate conduit for each distribution you receive so that there is no commingling of funds for different plans. For example, if you have a 403(b) and 401(k) from employer A, you would want a conduit for each. Avoid the temptation to consolidate.

If you are younger than 59 1/2, and you do not rollover the distribution — *i.e.*, you withdraw funds — you will be subject to ordinary income taxes *plus* an additional 10 percent tax on the amount you withdraw. There are, however, exceptions and strategies to avoid the penalties (but not the taxes).

You may be able to take money out of your retirement plan to pay family medical expenses and medical insurance premiums. Retirement plan distributions used to pay the portion of medical expenses exceeding 7.5 percent of your adjusted gross income (AGI) will avoid the early distribution penalty. (The whole distribution is still subject to regular income tax.) If you lose your job (and meet a host of other requirements), you may withdraw money from your plan to pay for medical insurance for yourself, your spouse, and your dependents and avoid the 10 percent penalty tax.

If you become disabled before you reach age 59½, any amounts that you withdraw from your plan will be exempt from penalty. You are considered disabled if you can furnish proof that you cannot do any substantial gainful activity because of your physical or mental condition. A physician must determine that your condition can be expected to result in death or to be of long, continued and indefinite duration.

Retirement plan rules allow you to withdraw funds, without penalty, for higher education expenses. Qualified expenses include tuition, fees, books, supplies, equipment, and room and board required for enrollment or attendance for you, your spouse, your children or grandchildren. The educational institution must be eligible to participate in the student aid programs administered by the Department of Education.

You may be eligible to withdraw up to $10,000 from your plan and avoid early withdrawal penalties under the first-time homebuyer exemption. The buyer may be you; your spouse; or you or your spouse's child, grandchild, or even ancestor. A first-time buyer is defined as a person that has not owned a home during the two-year period ending on the date the house is purchased. If both husband and wife are first-time homebuyers, they can each withdraw up to $10,000.

For those who wish to withdraw funds before age 59 1\2 for purposes other than those designated exempt from penalty by virtue of their use for education, homeownership, medical care, etc., the most widely available provision is the "substantially equal payments" rule. Under this requirement, distributions may be taken without penalty before age 59 1/2 if they are to be in equal annual installments, spread out over your life or the joint life of you and your retirement plan's beneficiary. You must take at least one distribution annually, and, unlike the minimum distribution requirement that allows markedly different withdrawals from year to year, the annual distributions must be "substantially equal." To qualify, you must have terminated your employment, if it is an employer's plan.

If you are at least 55 years old when you leave your job, any distributions you receive from your plan will not be assessed the penalty, even if you find new employment after leaving your old job.

Why Tax Savings At All?

Currently a host of retirement reforms are being introduced in Congress. One would create a universal qualified plan; that is, it would receive all the funds from all the different places you worked, and be portable. Others would increase the tax-deductible amounts that everyone (well, perhaps not) could contribute to employee and IRA plans; require faster vesting; create Roth 401(k) and Roth 403(b) plans; create SIMPLE-IRA plans that employers would not have to contribute to; and so on and so forth — *ad nauseam*.

These reforms all seem designed to perpetuate the culture in which political entrepreneurship has flourished through the creation of ever more "targeted" tax breaks favoring one or another special interest. Viewed from a political perspective, eliminating all special tax privileges and introducing genuinely sweeping change would be killing the goose that lays the golden eggs. The pursuit of patronage requires that advantages and disadvantages be maintained in some (ideally constantly changing) form. Otherwise the lawmakers would have nothing new to sell.

But that is precisely what is needed. It is too much to hope that all taxes on income — whether derived from labor or investment — will soon be eliminated. But it would be far preferable to eliminate all of today's "targeted tax breaks" in favor of fewer overall restrictions on contributions to and withdrawals from existing retirement accounts. In effect, even such a change — toward which the Roth IRA is already a significant step — would move the tax structure closer to a consumption tax. Rather than taxing individuals on what they put into the economy, they would be taxed on what they take out — which, one supposes, would simply provide the politicians with a whole new field to plow…. ❑

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