



# Individual Retirement Accounts and 401(k) Plans: Early Withdrawals and Required Distributions

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## Summary

In the interest of encouraging workers to save for retirement, Congress has authorized several kinds of retirement savings plans that qualify for reduced or deferred income taxes. These plans provide a financial incentive for people to save, either by allowing workers and employers to deduct from income the amount they contribute to the plan or to take tax-free distributions from the plan after they retire. This CRS report summarizes the provisions of law that govern the taxes applicable to pre-retirement distributions from retirement accounts, and the situations in which distributions must be taken from a plan in order to avoid a tax penalty.

Because tax-deductible contributions to retirement plans and deferral of taxes on investment earnings reduce federal income tax collections, Congress has placed limits on the amount that can be contributed to these plans each year. To assure that the tax preferences granted to retirement accounts are used to promote retirement income security rather than to subsidize transfers of wealth from one generation to the next, federal law requires owners of retirement accounts that are funded with tax-deductible contributions to begin taking required minimum distributions from the accounts after they reach age 70½. Failure to take a required minimum distribution will result in a tax penalty equal to 50% of the amount that should have been distributed. Retirement plans that are funded with after-tax income—like the “Roth IRA”—do not have required minimum distributions during the account owner’s lifetime.

To discourage individuals from taking pre-retirement withdrawals from retirement savings accounts, the Internal Revenue Code (I.R.C.) imposes a 10% penalty on withdrawals taken before age 59½, which is levied in addition to any other applicable income tax. Recognizing that some significant events might require people to withdraw money from their retirement accounts earlier than expected, Congress has provided in law for waiving the 10% early withdrawal penalty in some situations. As with required distributions after age 70½, Roth IRAs have a special rule with respect to early withdrawals. Because contributions to a Roth IRA must consist entirely of income on which income tax has already been paid, qualified distributions from a Roth IRA are not subject to income taxes or penalties.

In response to the steep decline in stock prices in 2008, which substantially reduced the value of many retirees’ retirement accounts, the House of Representatives on December 10, 2008, passed H.R. 7327, which would suspend for tax year 2009 the required minimum distributions for taxpayers who are over age 70½. On December 12, 2008, H.R. 7327 passed the Senate by unanimous consent. President Bush signed the bill on December 23, 2008.

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Because tax-deductible contributions to retirement plans and deferral of taxes on investment earnings reduce federal income tax collections, Congress has placed limits on the amount that employers and employees can contribute to these plans each year. As the Government Accountability Office has noted, “these limits exist to prevent partial public subsidies of excessively large retirement benefits through tax preferences.”<sup>1</sup> To ensure that the tax preferences granted to retirement accounts are used to promote retirement income security rather than to subsidize transfers of wealth from one generation to the next, Congress has required distributions from retirement accounts that are funded with tax-deductible contributions to begin when the account owner reaches age 70½. A taxpayer who does not take a required minimum distribution is subject to a tax penalty equal to 50% of the amount that should have been distributed. If these distributions were not required, the temporary tax deferrals that Congress has authorized to encourage retirement saving would become permanent tax exemptions for those whose income from other sources is high enough that they do not need to take withdrawals from their retirement savings to help pay their living expenses. Retirement plans that are funded with after-tax income—like the “Roth IRA”—do not have required distributions during the account owner’s lifetime.

To discourage individuals from taking pre-retirement withdrawals from retirement savings accounts, the Internal Revenue Code (I.R.C.) imposes a 10% additional tax on withdrawals taken before age 59½. This penalty is levied in addition to regular income taxes. Recognizing that some significant events might require people to withdraw money from their retirement accounts earlier than expected, Congress has provided in law for waiving the 10% early-withdrawal penalty in some situations. As with required minimum distributions, Roth IRAs have a special rule with respect to early withdrawals. Because contributions to a Roth IRA consist entirely of income on which income tax has already been paid, the full amount of Roth IRA contributions can be withdrawn at any time without being subject to additional income taxes or an early withdrawal penalty. Investment earnings on a Roth IRA are free of income taxes and penalties if withdrawn at least five years after the account was established and the account owner has reached age 59½.

## **Kinds of Retirement Savings Plans**

There are several kinds of retirement savings plans, the most common of which are *individual retirement accounts* (IRAs) and the employer-sponsored plans that are authorized under section 401(k) of the Internal Revenue Code. There are two types of individual retirement account: the “traditional IRA,” authorized by Congress in 1974, and the “Roth IRA,” which Congress authorized in 1997. The two types of IRA differ in the tax treatment of both contributions and distributions. In a traditional IRA, contributions may be tax-deductible (up to legal limits).

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<sup>1</sup> *Private Pensions: Issues of Coverage and Increasing Contribution Limits for Defined Contribution Plans*, GAO-01-846, September 2001, p. 1.

Investment earnings accrue on a tax-deferred basis. Distributions from the plan are taxed as ordinary income.<sup>2</sup> Contributions to a Roth IRA are not tax-deductible; however, qualifying distributions from a Roth IRA are tax-free. The tax treatment of a 401(k) plan is similar to that of a traditional IRA: contributions (up to legal limits) are excluded from income and investment earnings accrue on a tax-deferred basis. Distributions from the plan are taxed as ordinary income. The Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) authorized a “Roth 401(k)” beginning in 2006. Like the Roth IRA, Roth contributions to a 401(k) plan are made on an after-tax basis, and qualified distributions from the plan are tax-free.

## **Contribution Rules: Putting Money into a Retirement Account**

### **Contribution Rules for Traditional IRAs**

In 2008, a worker can make a tax-deductible contribution of \$5,000 (or annual earnings, if less) to a traditional IRA if he or she is under age 70½ and neither the worker nor his spouse is covered by an employer-sponsored retirement plan. Workers age 50 and older can make an additional “catch-up” contribution of \$1,000. For an unmarried worker who is covered by an employer-sponsored retirement plan, the deduction for tax year 2008 phases out between \$53,000 and \$63,000 of modified adjusted gross income.<sup>3</sup> For a married worker who is covered by a plan at work, the maximum deductible contribution for tax year 2008 phases out between \$85,000 and \$105,000 of modified A.G.I. For a married worker who files a joint return and does not have an employer-sponsored retirement plan, but whose spouse is covered by an employer’s plan, the maximum deductible contribution phases out between \$159,000 and \$169,000 of modified A.G.I.

If a traditional IRA has been funded entirely or in part by *after-tax* contributions, the after-tax contributions are deemed by the IRS to be a *pro rata* share of any distribution from the account. The account owner cannot declare all of the distribution to consist entirely of after-tax contributions, and therefore not subject to the income tax. If an individual owns more than one traditional IRA, and any of them have been funded with after-tax contributions, a distribution from *any* of the accounts will be treated as consisting partly of after-tax contributions.

### **Contribution Rules for Roth IRAs**

The Taxpayer Relief Act of 1997 (P.L. 105-34) authorized a new kind of retirement savings account—the “Roth IRA”—named for former Senator William Roth of Delaware. The distinguishing characteristics of the Roth IRA are that (1) contributions can be made at any age, (2) no distributions from the plan are required during the account owner’s lifetime and (3) contributions to the account are not tax-deductible, but qualifying distributions from the account are tax-free. Only individuals whose income is below thresholds defined in law are eligible to

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<sup>2</sup> Income is classified as either “ordinary income” or “capital gains.” For tax year 2008, the top marginal tax rate on ordinary income is 35%. The tax rate on capital gains is 15%.

<sup>3</sup> Modified AGI is adjusted gross income plus income from education savings bonds, interest paid on education loans, employer-provided adoption assistance benefits, IRA deductions, deductions for qualified higher education expenses, and some other adjustments.

contribute to a Roth IRA. For single tax filers, the maximum permissible contribution to a Roth IRA in 2008 phases out for those with modified adjusted gross income between \$101,000 and \$116,000. For married couples filing jointly, the maximum permissible contribution to a Roth IRA phases out between \$159,000 and \$169,000 of annual income.<sup>4</sup> For married persons filing separately, the contribution limit phases out between \$0 and \$10,000 of income. The total annual limit on contributions to all of an individual's IRAs (traditional deductible, traditional nondeductible, and Roth) is \$5,000 in 2008 (or \$6,000 for individuals age 50 and over). The contribution limit in future years will be indexed to the rate of inflation, as measured by the Consumer Price Index, in \$500 increments.

Because all contributions to a Roth IRA are made with after-tax income, the full amount of contributions (the account basis) can be withdrawn tax-free at any time. Distributions from a Roth IRA are deemed to come from contributions first, from "rollovers" second,<sup>5</sup> and account earnings last. Thus, distributions from a Roth IRA are deemed to consist entirely of after-tax contributions until the full amount of those contributions has been withdrawn. This assures that the account owner can withdraw the full amount that he or she has contributed without having to pay additional taxes or early withdrawal penalties on that amount. Distributions from a Roth IRA that exceed the account basis are taxable unless they are *qualified distributions*. These distributions also may be subject to a 10% additional tax if made before age 59½. Distributions that occur after the account owner has reached age 59½ and at least five years after the account was established are qualified distributions. Qualified distributions from a Roth IRA are tax-free.

## **Converting a Traditional IRA to a Roth IRA**

A traditional IRA can be converted to a Roth IRA, but a Roth IRA cannot be converted to a traditional IRA. Until 2010, only taxpayers with A.G.I. of \$100,000 or less (except those who are married and filing separately) can convert a traditional IRA to a Roth IRA.<sup>6</sup> The immediate consequence of converting a traditional IRA to a Roth IRA is that income tax must be paid on the entire amount that is converted, except for any amount that represents after-tax contributions. Any amount that is subject to income tax when a traditional IRA is converted to a Roth IRA must remain in the Roth IRA for at least five years—or until the account owner reaches age 59½, if earlier—or it will be subject to the 10% additional tax on early distributions. If a distribution occurs less than five years after the conversion, the amount that was taxable in the year of the conversion will be subject to the 10% early withdrawal penalty unless the account owner has reached age 59½.<sup>7</sup>

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<sup>4</sup> The income limit for converting a traditional IRA to a Roth IRA is lower. In tax years before 2010, if modified adjusted gross income (AGI) exceeds \$100,000 for either a single filer or a married couple, then a traditional IRA cannot be converted to a Roth IRA.

<sup>5</sup> A "rollover" is a deposit that came directly from another tax-qualified retirement account.

<sup>6</sup> P.L. 109-222 (May 16, 2006) repealed the \$100,000 income limit for converting a traditional IRA to a Roth IRA beginning in 2010.

<sup>7</sup> Distributions that occur after five years have passed and after age 59½ are "qualified distributions" and are not subject to either ordinary income taxes or tax penalties.

## **Contribution Rules for Employer-Sponsored Plans**

Under section 401 of the Internal Revenue Code, employers can establish retirement plans that qualify for beneficial tax treatment, including a tax deduction for employer contributions and deferral of income taxes on employee contributions and investment earnings. Section 401(k) allows employers to establish plans in which employees can choose to take their compensation in cash or to defer part of it in the form of a contribution to a retirement plan—called an “elective deferral.” These plans—popularly known as 401(k) plans—are referred to in the tax code as “cash or deferred arrangements.” Non-profit educational and cultural organizations can offer similar retirement plans under I.R.C. §403(b). State and local governments and tax-exempt organizations can offer deferred compensation arrangements under I.R.C. §457. Although the plans authorized under I.R.C. §401(k), §403(b), and §457 differ from each other in some respects, effective with the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16), balances in one type of plan generally can be rolled over into either of the others, or into an IRA.

The maximum permissible employee salary deferral under a 401(k) plan in 2008 is the lesser of \$15,500 or 100% of compensation.<sup>8</sup> Under the terms of the Economic Growth and Tax Relief Reconciliation Act, the maximum deferral in years after 2006 is indexed to inflation. The maximum salary deferral in 2009 will be \$16,500. Participants aged 50 or over can make additional “catch-up” deferrals of up to \$5,000 in 2008. The maximum annual addition to a defined contribution plan—the sum of employer and employee contributions—is the lesser of \$46,000 or 100% of compensation in 2008.<sup>9</sup> This limit is indexed to the Consumer Price Index (CPI) in \$1,000 increments. The annual contribution limits and the minimum distribution rules for §403(b) plans are the same as for 401(k) plans. Since January 1, 2006, participants in 401(k) and 403(b) plans have been permitted to elect “Roth” treatment for their contributions, if their plan chooses to permit them to do so. Such contributions are made on an after-tax basis, but qualified distributions from the account are tax-free. There is no required minimum distribution from a Roth 401(k) during the employee’s lifetime or that of the employee’s spouse, but any beneficiary other than the account owner’s spouse is subject to required minimum distributions.

State and local governments and tax-exempt organizations can establish deferred compensation arrangements under I.R.C. §457.<sup>10</sup> Participants’ contributions to these plans are excluded from income, and plan earnings are tax-deferred until withdrawal. The maximum permissible contribution to a §457 plan is the lesser of 100% of compensation or \$15,500 in 2008.<sup>11</sup> Participants in §457 plans can make additional contributions of up to twice the standard amount in the last three years before normal retirement age. Participants who are 50 or older can make additional “catch-up” contributions of up to \$5,000 in 2008. The EGTRRA of 2001 repealed the rules that coordinated the maximum annual employee contribution to a §457 plan with the contribution limits for other types of plans. Consequently, an employee who participates in a §457 plan and who also participates in either a §403(b) or a §401(k) plan is permitted to contribute up to \$15,500 to each plan in 2008. Section 457 plans also are subject to a special rule with respect to distributions. These plans are not subject to the 10% penalty for withdrawals before age 59½, provided that the withdrawal occurs upon retirement or termination of employment.

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<sup>8</sup> 26 U.S.C. §402(g).

<sup>9</sup> 26 U.S.C. §415(c). The maximum annual addition to a DC plan in 2009 will be \$49,000.

<sup>10</sup> Tax-exempt organizations are described in I.R.C. §501(c)(3).

<sup>11</sup> 26 U.S.C. §457(e).

## Distribution Rules: Withdrawing Money from a Retirement Account

### Additional Tax on Early Distributions

Section 72(t) of the Internal Revenue Code applies a tax equal to 10% of the amount distributed from a “qualified retirement plan.”<sup>12</sup> The 10% additional tax is levied in addition to regular income taxes *unless* the distribution from the retirement plan is made

- (1) after the plan participant has reached age 59½;
- (2) to a beneficiary after the death of the participant;
- (3) because the participant has become disabled;
- (4) to an alternate payee under a qualified domestic relations order (QDRO);<sup>13</sup>
- (5) to an employee who has separated from service under an early retirement arrangement after reaching age 55;<sup>14</sup>
- (6) as dividends paid from an Employee Stock Ownership Plan (ESOP);
- (7) through an IRS levy to collect back taxes owed by the plan participant;
- (8) to pay medical expenses of the plan participant, a spouse, or dependent, but only to the extent that they exceed 7.5% of adjusted gross income; or
- (9) as part of a series of *substantially equal periodic payments* (SEPPs) over the life of the participant or the joint lives of the participant and a designated beneficiary.

### Special Rules for Traditional IRAs

Two of the exceptions to the 10% penalty apply *only* to employer-sponsored plans, and not to individual retirement accounts. These are distributions to an alternate payee under a QDRO and distributions to a worker who has retired after reaching age 55 but before age 59½. There are, however, three additional exceptions to the 10% early withdrawal penalty that apply *only* to IRAs. Distributions from an individual retirement account made before age 59½ are not subject to the 10% early withdrawal penalty if the distributions are used

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<sup>12</sup> A qualified retirement plan is defined in statute at 26 U.S.C. §4974(c) as “(1) a plan described in section 401(a) which includes a trust exempt from tax under section 501(a), (2) an annuity plan described in section 403(a), (3) an annuity contract described in section 403(b), (4) an individual retirement account described in section 408(a), or (5) an individual retirement annuity described in section 408(b).”

<sup>13</sup> A Qualified Domestic Relations Order divides the assets of a couple at divorce. The alternate payee is usually a former spouse and/or a minor dependent of the divorced couple.

<sup>14</sup> The individual is not prohibited from being employed, or even from returning to work for the same employer, but there must be a period of separation that began after age 55.



- to pay health insurance premiums during a period of unemployment;
- to pay for qualifying post-secondary educational expenses; or
- to pay up to \$10,000 of the cost of purchasing a first home.

There are restrictions on each of these three exceptions. The exception for paying health insurance premiums applies only if the account owner (1) has received unemployment compensation for at least 12 consecutive weeks, (2) receives the distribution either in the same year that unemployment compensation was received or in the following year, and (3) receives the distribution no later than 60 days after returning to work.

The exception for higher-education expenses applies to either the account owner or the account owner's spouse, child, or grandchild, but only if (1) the distribution is used to pay for tuition, fees, books, supplies, equipment, or room and board, and (2) the distribution is no greater than the sum of eligible expenses, minus the amount of any tax-free assistance or scholarships that the student receives, excluding loans, gifts, or inheritances.

For purposes of the exception to the 10% early withdrawal penalty, a "first-time home buyer" is defined as someone who did not own (and whose spouse did not own) a principal residence in the two years preceding the distribution from the account. The exception for a first-home purchase has a lifetime limit of \$10,000. The distribution must be used to purchase, build, or re-build the principal residence of the account owner, the account owner's spouse, or the parent or grandparent, or the child or grandchild of the account owner or the account owner's spouse. In addition, the distribution must be used within 120 days or else rolled over into another IRA.

## **Early Withdrawals Without Penalty: "Substantially Equal Periodic Payments"**

Section 72(t) of the Internal Revenue Code states that, if distributions from a qualified retirement plan made before age 59½ are "part of a series of substantially equal periodic payments," they are not subject to the 10% penalty that otherwise would apply.<sup>15</sup> Under this exception to the 10% early withdrawal penalty, an account owner can begin taking distributions from a retirement plan at any age; however, these distributions can be taken only from a plan sponsored by a former employer or from an IRA. The distributions also

- (1) must be paid at least once each year;
- (2) must be based on the life expectancy of the plan participant or the joint life expectancy of the participant and a designated beneficiary; and
- (3) must *not* be modified before the *later of* five years after the first distribution or the date on which the plan participant reaches age 59½.

The Internal Revenue Service has defined in regulation the forms of distribution that it will consider to be "substantially equal periodic payments" and therefore will not be subject to the

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<sup>15</sup> 26 U.S.C. §72(t)(2)(A)(iv).

10% tax penalty otherwise applicable to early withdrawals.<sup>16</sup> The IRS has approved three methods for calculating substantially equal periodic payments. They are

- the *minimum distribution method*, also called the life expectancy method;
- the *amortization method*, which amortizes an account balance using life expectancy tables and a “reasonable” interest rate; and
- the *annuitization method*, which divides the account balance by an annuity factor based on a “reasonable” mortality table and interest rate.

For any individual, each of the three methods may produce a different distribution amount. As its name implies, the *minimum distribution method* will usually result in the smallest annual distribution. It is also the only one of the three methods in which the amount of the distribution is likely to vary from year to year. The distribution amount varies both because of changes in the remaining account balance and changes in the account owner’s remaining life expectancy. The amortization method and the annuitization method usually produce distributions that are similar in size because the same economic and demographic variables determine the distribution amounts under both of these methods. The distribution amount is calculated *annually* under the minimum distribution method. Under the amortization and annuitization methods, this calculation is typically performed only before the first distribution and the distribution remains unchanged from year to year.

One way to receive a larger annual distribution than would result from the minimum distribution method, but smaller than the distribution produced by either of the other two methods, is to “segment” one’s retirement accounts into two or more IRAs. Distributions can then be taken from one (or more) of them while leaving the others intact. According to one authoritative source, “IRS rulings have consistently allowed taxpayers to take periodic payments from one or more plans and not others.”<sup>17</sup>

## **The Minimum Distribution Method**

Under the minimum distribution method, the annual distribution in any year is determined by dividing the account balance for that year by the account owner’s remaining life expectancy, (or the joint life expectancy of the account owner and his or her designated beneficiary) as published in a life expectancy table that has been approved by the IRS. Because the account balance and the account owner’s remaining life expectancy change from year to year, the distribution amount also will change each year under this method.

Although the amount of the distribution will change each year under the minimum distribution method, the IRS treats the resulting distributions as substantially equal periodic payments for purposes of section 72(t). Once the distributions have begun, however, the account owner may neither stop receiving payments nor switch to one of the other two methods until *the later of* (1) five years after the first distribution or (2) the date on which the plan participant reaches age 59½. Terminating or altering the distributions before the later of these two dates will result in a penalty

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<sup>16</sup> I.R.S. Notice 89-25 (March 20, 1989) and Revenue Ruling 2002-62 (October 3, 2002).

<sup>17</sup> Twila Slesnick and John C. Suttle, *IRAs, 401(k)s, and Other Retirement Plans: Taking Your Money Out*, Fourth Edition, (2002), page 4/4.

of 10% (plus interest) being levied retroactively on all distributions that have been made from the plan.

### **The Amortization Method**

Under the amortization method, the amount of the annual distribution is based on the account owner's remaining life expectancy in the year of the first distribution and a "reasonable" rate of interest. (If the account owner has a designated beneficiary, the distribution is based on their joint life expectancies in the year of the first distribution.) Under this method, the account balance and remaining life expectancy are determined only for the first distribution year. The annual distribution is the same amount in each succeeding year. The risk to the account owner who chooses the amortization method is that a declining account balance might result in the account being exhausted in fewer years than he or she had expected when the distributions began.

### **The Annuitization Method**

Under the annuitization method, the distribution amount is determined by dividing the account balance by an *annuity factor*. This factor represents the present value<sup>18</sup> of an annuity of \$1 per year beginning at the taxpayer's current age and continuing for the life of the account owner (or the joint lives of the account owner and a designated beneficiary). The annuity factor must be derived from life expectancy tables published by the Internal Revenue Service and an interest rate that does not exceed 120% of the federal mid-term rate.<sup>19</sup> Under this method, the account balance, the annuity factor, and the interest rate are determined only once, for the first distribution year. The resulting annual payment is the same amount in each succeeding year. In private letter rulings, the IRS generally has allowed the distribution amount to be adjusted annually to account for changes in life expectancy and account balance. The IRS also has issued private letter rulings that allow the annual distribution to be increased for inflation. A private letter ruling, however, applies *only* to the individual who requested it. These rulings cannot be relied upon by other taxpayers as legally binding statements of IRS policy.

### **Examples**

Consider a 55-year-old unmarried individual with no designated beneficiary who began taking substantially equal periodic payments in October 2008. The two relevant variables for determining the distribution amount under the *minimum distribution method* are the account balance and the account owner's remaining life expectancy, which for a 55-year-old is 29.6 years.<sup>20</sup> If we assume an account balance of \$100,000 on September 30, 2008, the first-year distribution would be \$3,378, which is derived by dividing the account balance by the

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<sup>18</sup> A present value is the lump-sum equivalent of a series of payments or stream of income. Present value depends mainly on the length of time over which the money will be paid and the rate of interest at which these payments will be discounted to the present.

<sup>19</sup> The current federal mid-term rate can be found on the IRS website at <http://www.irs.gov/taxpros/lists/0,,id=98042,00.html>.

<sup>20</sup> IRS Publication 590, Appendix C, Table 1. In *Arizona Governing Commission for Tax Deferred Annuity & Deferred Compensation Plans v. Norris*, 463 U.S. 1073 (1983), the Supreme Court held that an employer-sponsored plan using sex-segregated life expectancy tables to calculate annuity payments had violated Title VII of the Civil Rights Act of 1964. As a result of this decision, annuities paid from employer sponsored retirement plans must use "unisex" life tables. The ruling does not apply to individually purchased annuities, which may use gender-specific life tables.

individual's remaining life expectancy. In each succeeding year, the annual distribution amount would be determined by the same process—dividing the remaining account balance (which may have increased or decreased depending on investment returns) by the individual's remaining life expectancy, which will decrease each year. Because the minimum distribution method takes into account changes in both the account balance and remaining life expectancy, the annual distribution amount will change from year to year under this method.

Under the *amortization method*, the annual distribution for an individual in the circumstances described above would be \$5,824.<sup>21</sup> The annual distribution under this method is determined the same way that a loan repayment is calculated. The account balance is analogous to the principal of the loan, the term is the person's remaining life expectancy in the year that the first distribution is made, and the interest rate is equal to or less than 120% of the mid-term federal interest rate in either of the two months immediately preceding the first distribution. Under the amortization method, the amount of the annual distribution is determined once, before the first distribution, and it remains the same from year to year.

Under the *annuitization method*, the annual distribution for an individual in the circumstances described above also would be \$5,824.<sup>22</sup> The variables that determine the annual distribution under the annuitization method are, as under the amortization method, the individual's remaining life expectancy and an interest rate. As a result, the distribution amounts under these two methods are likely to be nearly the same, provided that similar interest rates are used. The distribution amount is easier to compute under the annuitization method because the interest rate and life expectancy factors have been combined into a single number called an *annuity factor*. There is a single annuity factor for each possible combination of interest rate and term (life expectancy). These factors are readily available in published sources such as *McGraw-Hill's Compound Interest Annuity Tables* and *Archer's Compound Interest and Annuity Tables*. To find the annual distribution amount, the account balance is simply divided by the annuity factor appropriate to the individual's age and the applicable rate of interest.

## Revenue Ruling 2002-62

Both the amortization method and the annuitization method of calculating substantially equal periodic payments result in distribution amounts that are constant from year to year and that are larger than the initial distribution that results from the minimum distribution method. In October 2002, the Internal Revenue Service released Revenue Ruling 2002-62, which allows taxpayers to make a one-time switch from either the amortization method or the annuitization method to the minimum distribution method of calculating the annual distribution from their retirement plans. The smaller distributions that result from this switch will prevent retirement accounts from being depleted as rapidly as would occur under either of the other two methods.

Revenue ruling 2002-62 also states that

- If an account owner takes periodic payments (SEPPs) and his or her account is exhausted before age 59½, the IRS will not treat this as a “modification” of the

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<sup>21</sup> Amount is based on an interest rate of 4.0% and a remaining life expectancy of 29.6 years.

<sup>22</sup> This is based on an annuity factor of 17.1687.

See <http://www.studyfinance.com/common/table4.pdf> for the annuity factors used.

- method of distribution and will not assess the 10% penalty and retroactive interest changes that otherwise would be levied.
- An interest rate of up to 120% of the federal mid-term rate for either of the two months immediately preceding the month in which the distribution begins can be used under either the amortization or annuity methods.
  - A distribution can be based on the account balance on December 31 of the previous year or any date in the current year prior to the first distribution. In subsequent years, under the minimum distribution method, the distribution can be based on the value either on December 31 of the prior year or on a date within a reasonable period before that year's distribution.
  - Distributions can be based on any one of the three life expectancy tables published by the IRS in Publication 590. (The *Single Life Expectancy* table yields the highest annual distribution). Also, a new mortality table for the annuity method, published in Appendix B of Revenue Ruling 2002-62, must be used for SEPPs starting on or after January 1, 2003. The new tables reflect increases in life expectancy and decreasing mortality.

## Required Minimum Distributions

In order to encourage employers to sponsor retirement plans and employees to participate in these plans, Congress has amended the Internal Revenue Code to (1) allow employer contributions to qualified retirement plans to be treated as tax-deductible business expenses, (2) exclude employer contributions to retirement plans and investment earnings on those plans from employee income, and (3) permit qualifying employee contributions to individual retirement accounts and certain employer-sponsored plans to be excluded from taxable income in the year the contribution is made and to exclude investment earnings on these contributions from annual income. These contributions and investment earnings are taxed when the retirement account is distributed to the plan participant, usually during retirement.

To ensure that tax-deferred retirement accounts that have been established to provide income during retirement are not used as permanent tax shelters or as vehicles for transmitting wealth to heirs, Congress has required plan participants to begin taking distributions from these plans no later than April 1 of the year after they reach age 70½.<sup>23</sup> Participants in employer-sponsored plans who are still working at age 70½ can delay distributions until April 1 of the year after they have retired. This exception does not apply to traditional IRAs.<sup>24</sup> In a traditional IRA, the required beginning date for distributions is always April 1 of the year after the participant reaches age 70½. The distributions must be made over the life expectancy of the plan participant, or over the joint life expectancy of the plan participant and his or her designated beneficiary. Failure to take a required distribution will result in a tax penalty equal to 50% of the amount that should have been distributed.<sup>25</sup>

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<sup>23</sup> 26 U.S.C. §401(a)(9).

<sup>24</sup> Distributions are not required from a Roth IRA during the account owner's lifetime.

<sup>25</sup> 26 U.S.C. §4974.

The tax code requires that either the entire retirement account balance must be distributed by the required beginning date, or that distributions must have begun by that date with the amount of the distributions based on the remaining life expectancy of the account owner (or the joint life expectancy of the account owner and a designated beneficiary.)<sup>26</sup> For most participants in employer-sponsored plans, the “required beginning date” for distributions is April 1 of the calendar year following the *later of* (1) the year in which the plan participant reaches age 70½, or (2) the year in which he or she retires.<sup>27</sup> If the plan participant owns 5% or more of the company, however, the required beginning date is always April 1 of the year after the participant reaches age 70½, regardless of whether he or she has retired.

If required minimum distributions have begun but the account owner dies before the entire account balance has been distributed, the remainder of the account must be distributed at least as rapidly as under the distribution method that was being used when the account owner died. The account must then be distributed over the remaining life expectancy of the designated beneficiary, or if there is no designated beneficiary, over a length of time equal to the remaining life expectancy of the decedent in the year of his or her death.

If an account owner dies before the required distributions from the account have begun and no beneficiary has been designated, the entire account balance must be distributed within five years after the death of the account owner. Any amount that is to be paid to a designated beneficiary can be distributed over his or her life expectancy, provided that the distributions begin no later than one year after the date of the account owner’s death. If the designated beneficiary is the surviving spouse of the account owner, then the required beginning date for distributions is the date on which the account owner would have reached age 70½.<sup>28</sup> The account balance for determining the amount of the required distribution each year is the balance on the last valuation date in the year preceding the distribution.<sup>29</sup> In most cases, this will be December 31. A surviving spouse who is the sole designated beneficiary also has the option to roll over the account into an IRA in his or her own name. In that case, the surviving spouse generally will have to wait until age 59½ to begin taking distributions, just as if the IRA had always been in the surviving spouse’s name.

Section 634 of the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) directed the Secretary of the Treasury to modify the life expectancy tables under the regulations relating to required minimum distributions so that the tables reflect current life expectancy. The IRS issued the required regulations on April 17, 2002.<sup>30</sup> The new regulations incorporate life tables that reflect increases in life expectancy since the 1980s, when the tables were last published. Consequently, the minimum required annual distribution is smaller than under the old life tables, because an account balance now will be distributed over a longer expected life span.

Required distributions do not compel account owners to sell the stocks, bonds, or other assets in which a retirement account is invested. The law requires funds to be withdrawn from the

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<sup>26</sup> Life expectancy may be redetermined annually. (See 26 U.S.C. §401(a)(9)(D)).

<sup>27</sup> If a plan participant retires after reaching age 70½, the employee’s accrued benefit must be actuarially increased to take into account the period after age 70½ in which the employee was not receiving any benefits under the plan. (See 26 U.S.C. §401(a)(9)(C)(iii)).

<sup>28</sup> Any distribution required under an incidental death benefit requirement is treated as a required minimum distribution.

<sup>29</sup> 26 C.F.R. §1.401(a)(9)-5, published in the *Federal Register*, vol. 67 no. 4, April 17, 2002.

<sup>30</sup> *Federal Register*, vol. 67 no. 74, April 17, 2002, pages 18988 to 19028.

retirement account and income taxes paid on the amount withdrawn, but this requirement this does not require assets to be sold. Stocks, for example, can be transferred from an IRA to a regular brokerage account. If assets that have been transferred from a retirement account to a regular account later increase in value, the increase will be taxed as capital gains, which are taxed at lower rates than ordinary income. If the age at which distributions are required were to be pushed beyond age 70½, future distributions would probably be larger because required distributions are based on both the account value and the account owner's remaining life expectancy. For any given account balance, a required distribution beginning at age 75, for example, would be greater than a distribution beginning at age 71, because the account owner will have a shorter remaining life expectancy. Larger annual distributions could push some retirees into higher tax brackets.

Eliminating required distributions altogether would, of course, provide account owners with the maximum freedom of choice about when to take distributions from their accounts.<sup>31</sup> The accounts eventually would be subject to taxation because, under current law the designated beneficiary usually is required to take withdrawals over his or her life expectancy. Some accounts also might be subject to the estate tax. In fact, however, extending the tax deferral period would benefit only those account owners whose income from other sources is sufficient to allow them to postpone withdrawals from their retirement accounts. Retirees who need to take distributions from their retirement accounts to supplement their retirement income, rather than because they are required by law to do so, would not benefit from delaying or eliminating the beginning date for required distributions. Lower and middle-income retirees who need to take distributions to support themselves in retirement would still have to take distributions from their accounts and pay income taxes on those distributions if their income is above the threshold for taxation.

One of the attractions of the Roth IRA is that no distributions are required from these plans during the account owner's lifetime. After the Roth IRA was authorized by Congress in 1997, many owners of traditional IRAs converted their accounts to Roth IRAs and paid income tax on the amounts that they converted. Some of those who converted their traditional IRAs to Roth IRAs might be unhappy if Congress were to eliminate required distributions from traditional IRAs. This would grant to current IRA owners free of charge a benefit that others purchased by converting their traditional IRAs to Roth IRAs and paying income taxes on the converted amounts.

## **How Many People Are Subject to RMDs?**

Required minimum distributions from a traditional IRA or from a 401(k) account owned by a retired worker must begin no later than April of the year after the account owner reaches age 70½. In 2005, an estimated 16.9 million households were headed by persons aged 70 and older, and 5.5 million (32.5%) of these households owned at least one IRA or 401(k)-type retirement account. Of the 5.5 million households potentially subject to required minimum distributions in 2005, 2.9 million (53%) had retirement account balances of less than \$50,000 and 938,000 (17%) had balances of more than \$200,000. (See **Table 1.**) Almost 3.6 million (65%) of the households potentially subject to RMDs had total income of less than \$50,000 in 2005, while 415,000 households (7.6%) had total income of more than \$100,000.

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<sup>31</sup> Roth IRAs have no minimum distribution requirement during the account owner's lifetime. Roth IRAs are funded only with contributions on which income taxes have already been paid. The investment earnings of a Roth IRA are available tax-free in retirement.

**Table I. Number of Households Headed by Persons Age 70 or Older with an IRA or 401(k) Account in 2005**

(number of households, in thousands)

<b>Total Household Retirement Account Balance</b>					
	<b>Under \$50,000</b>	<b>\$50,000 to \$99,999</b>	<b>\$100,000 to \$199,999</b>	<b>\$200,000 or more</b>	<b>Total</b>
<b>Age of Householder</b>					
70 to 79	1,992	667	597	715	3,971
80 or older	915	245	140	223	1,524
<b>Household Income</b>					
Under \$50,000	2,074	633	345	534	3,586
\$50,000-\$99,999	699	225	279	291	1,494
\$100,000 or more	135	54	114	112	415
<b>Total</b>	<b>2,908</b>	<b>912</b>	<b>737</b>	<b>938</b>	<b>5,495</b>

**Source:** Bureau of the Census, Survey of Income and Program Participation.**Notes:** Total household retirement account balance is the sum of all individual retirement account balances and defined contribution plan balances of all members of the household.

## One-Year Moratorium on RMDs in 2009

Individuals who fail to take required distributions from a retirement account are subject to a tax penalty equal to 50% of the required distribution. On December 10, the House of Representatives passed H.R. 7327, which would suspend the 50% tax for failure to take a required minimum distribution in 2009.<sup>32</sup> On December 12, 2008, H.R. 7327 passed the Senate by unanimous consent. President Bush signed the bill on December 23, 2008.<sup>33</sup>

## Plan Loans

The Internal Revenue Code allows participants in employer-sponsored plans to borrow from their accounts, but plans are not required to allow such loans. A loan cannot exceed the greater of \$10,000 or 50% of the participant's vested account balance. In no case may it exceed \$50,000. A loan from a retirement plan must be paid back within five years at a "reasonable" rate of interest. If repayment ceases, the IRS will treat the full amount of the loan as a distribution from the plan, and it will be subject to income tax and possibly to an early distribution penalty. If the employee separates from the employer before the loan is repaid, the full amount must be repaid, or it will be treated as a distribution from the plan.<sup>34</sup>

<sup>32</sup> Section 201 of H.R. 7327 provides that distribution under Internal Revenue Code §401(a)(9) will not be required in 2009. The temporary suspension of RMDs applies to all retirement plans under IRC §401 and §403, to plans under §457 maintained by units of state and local governments, and to individual retirement accounts.

<sup>33</sup> "Bush to Sign Pension Funding Relief Bill, White House Spokesman Says," *Daily Tax Report*, BNA, December 18, 2008.

<sup>34</sup> Loans are not permitted from IRAs, but money in an IRA can, in effect, be "borrowed" for 60 days because the law (continued...)



## Hardship Distributions

The tax code permits 401(k) plans—and no other kind of tax-qualified retirement plan—to make distributions available “upon hardship of the employee.”<sup>35</sup> Although the I.R.C. allows plans to make these distributions available, it does not require them to do so. Federal regulations specify that a hardship distribution can be made only on account of “an immediate and heavy financial need of the employee” and cannot exceed the amount of the employee’s previous elective contributions.<sup>36</sup> Qualifying expenses include medical care for the participant and/or family members, the purchase of a principal residence, college tuition and related expenses, expenses to prevent eviction or foreclosure on a principal residence, and funeral expenses. The distribution must be limited to the amount needed to meet the employee’s immediate financial need plus any taxes that will result from the distribution. Employees are prohibited by law from making contributions to a plan for a period of six months after a hardship distribution. Hardship distributions are always subject to ordinary income taxes, but if the distribution is used for a purpose specifically designated in IRC section 72(t) the distribution will not be subject to the 10% early withdrawal penalty, even if the plan participant is under age 59½.<sup>37</sup>

## Roth IRA Distributions

Distributions of investment earnings from a Roth IRA are subject to regular income taxes and early withdrawal penalties unless they are *qualified distributions*. Qualified distributions are those that occur after age 59½ and more than five years after the account was established. Investment earnings withdrawn from a Roth IRA before age 59½ are subject to both regular income taxes and a 10% early-withdrawal penalty. Distributions of investment earnings after age 59½ are not subject to the early withdrawal penalty, but they are subject to regular income tax if the distribution occurs less than five years after the account was established. Unlike a traditional IRA, from which required minimum distributions must begin no later than April 1 of the year after the account owner reaches age 70½, there is no requirement for an account owner to take distributions from a Roth IRA at any time during his or her lifetime.

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(...continued)

states that any distribution from an IRA that is not deposited in the same or another IRA within 60 days is a taxable distribution. (26 U.S.C. § 408(d)).

<sup>35</sup> 26 U.S.C. §401(k)(2)(B)(i)(IV). It is not necessary for the tax code to include a provision allowing hardship distributions from an IRA because a participant can always withdraw money from an IRA. Such distributions are always taxable, except any portion that is attributable to after-tax contributions. I.R.C. §72(t) describes the kinds of distributions made before age 59½ that are exempt from the 10% additional tax on early distributions.

<sup>36</sup> 26 C.F.R. §1.401(k)-1(d).

<sup>37</sup> Although the I.R.C. allows distributions to be made without penalty beginning at age 59½, many employer plans allow distributions only after the employee has left the employer.

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