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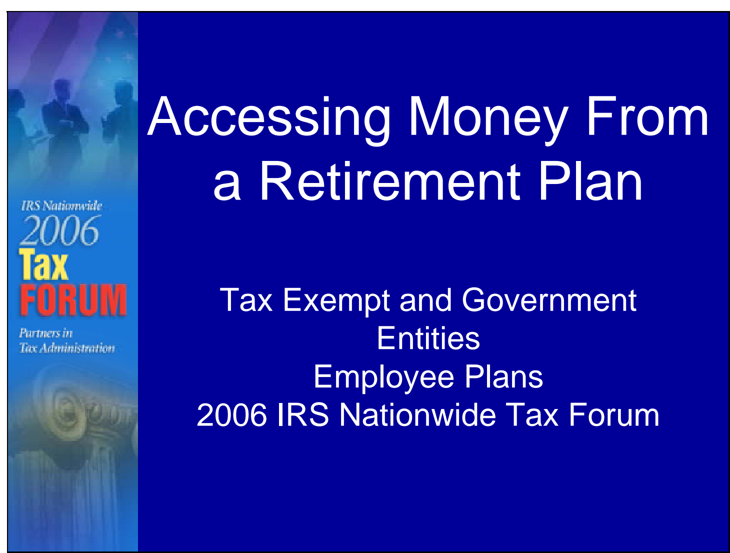


Howdy.

I'm "State Your Name" and I "State Your Qualifications for Speaking."

Money…how many of you here would like some? Think your clients might like some? How about their employees…or yours?

Now, if you or your clients have retirement plans, you may have another way to access some money. Granted, retirement plans are called "retirement" plans for a very good reason: they're used to save for and provide for retirement. But…sometimes there comes a reason or a circumstance to access retirement plan money *before* someone actually retires.

Then again, some people don't feel they *need* to access their retirement funds when they retire. Or they want to pass on the value of their retirement account to their family when they pass on. Once again, they're called "retirement" plans for a reason.

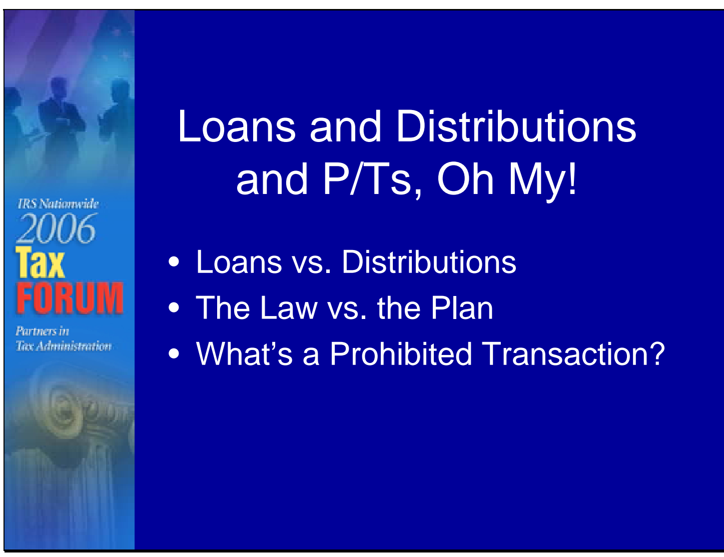
In today's show, I'll provide you with information on ways to access retirement money *before* retirement: loans and rollovers and pre-retirement distributions. I'll also talk about *required* distributions. We'll discuss the differences between distributions from "regular" plans vs. those from the new Roth 401(k) accounts. Finally, I'll talk to you about things that can go wrong w/ retirement fund assets and distributions, things known as "prohibited transactions."

And if there's time, I'll show you slides from my last family vacation. Highlights include the World's Largest Ball of Twine and the Barbed Wire Museum!

This presentation, along with the notes – but not the family vacation material – will be posted to our web site, www.irs.gov/ep in September after the final Tax Forum in New York. So if you miss anything during my discussion, please visit our web site to view the presentation.

But now it's time to Access Money from a Retirement Plan…and away we go!

Slide 2



There are lots of reasons for and ways to get money out of a retirement plan prior to actually retiring. And even though we'll be discussing those reasons and methods, we wholeheartedly recommend that people keep their retirement savings in their retirement savings vehicles until they retire.

Y'all know about Albert Einstein, his Relativity Theory and his pipe, right? Here's what he had to say about money and interest: "The most powerful force in the universe is compound interest." Accordingly, encourage your clients and their employees to be an Einstein and keep their money in the plan and take advantage of the most powerful force in the universe, Compound Interest, if at all possible.

But…we realize that there are times and circumstances when accessing retirement money is unavoidable, even necessary.

Now, folks need to know the consequences of using retirement plan money prior to retirement. For example:
Plan provisions – Does the plan allow for it?
Income tax – There are income tax questions.
Repayment possibilities – Take a loan or a distribution?
Additional taxes – Some early distributions are subject to an additional tax.
Impact on future retirement – i.e., loss of compounding.

Let's start w/ a look at "Loans vs. Distributions":

Loans get repaid and generally aren't included in income; distributions don't (get repaid) and are (includable in income).

Many pre-retirement distributions are subject to a 10% additional tax *in addition to* being included in income. Loans, *if handled correctly*, are not subject to any tax.

Plans may/may not allow for loans even though the law permits them.

And this brings up an important point: *Even if the law permits it, the plan has to provide for it.* That is, the plan document must explicitly state that such loan/distribution is allowed. Plans can always be amended to add these provisions, law permitting. But many plan administrators don't like these provisions because they can be burdensome/troublesome to administer, esp. loans and their repayment.

And the final part of our introduction: P/Ts, or Prohibited Transactions. Basically, a P/T is any "improper" use of retirement plan assets by the account holder, beneficiary or "disqualified person." We'll discuss P/Ts further later on in the show.

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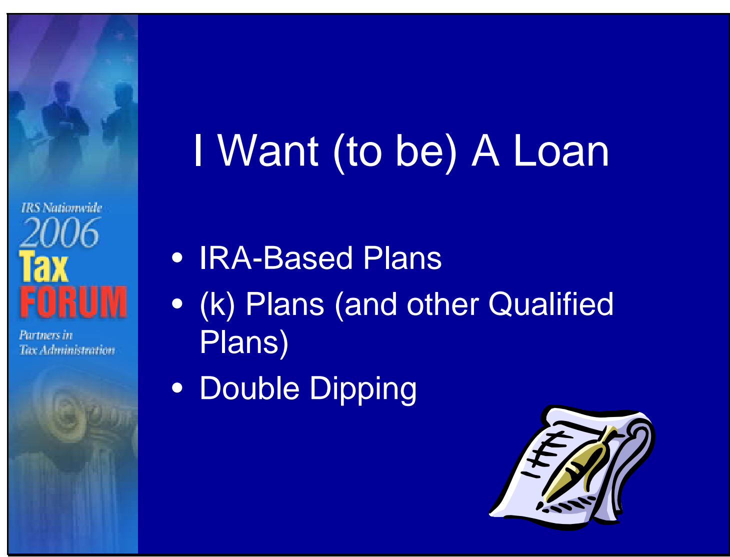

The first early way – and let me state that by "early" what I mean is pre-retirement – to access retirement plan money that we'll discuss is taking a loan.

Loans in general:

First, *loans are not allowed in IRA-based plans* like SEPs, SARSEPs, SIMPLE IRA Plans and plain, old-fashioned "personal" (or "traditional") IRAs. A loan from an IRA is a P/T and causes the IRA to cease being an IRA. So if you take a loan from an IRA, the whole IRA is included in your income.

In addition, if part of an IRA is used for collateral, that part becomes income. You may have to pay an additional 10% tax on this amount, which is now an "early distribution."

Now let's take a look at 401(k) and other qualified plans (***BTW:*** A "qualified plan" is one that satisfies the requirements of IRC section 401(a). Examples include profit-sharing and defined benefit plans and ESOPs. But since most of y'all are familiar w/ 401(k) plans, that's the term – k plan – that I'll use most often here.)

It's important here to re-state that even though ***the law*** allows for loans from a 401(k) plan, ***the plan*** itself must contain language allowing for them.

So…how much can a participant take as a loan?

Answer: Up to 50% of their vested account balance but no more than $50,000.

Loans decrease the amount in the account that could otherwise be getting earnings and thereby losing the force of compound interest.

Plans can have a loan limit less than the $50,000 figure but not a higher one.

Before we go any further, if the participant is married, their spouse may have to consent to the loan.

And some of you may be wondering if someone can “Double Dip,” or have more than one loan at a time?

The answer is “yes.” If there’s a loan w/in one year prior to the new loan, the $50,000 figure discussed before is reduced by the highest outstanding balance during that year. This includes renegotiated loans unless certain conditions are met.

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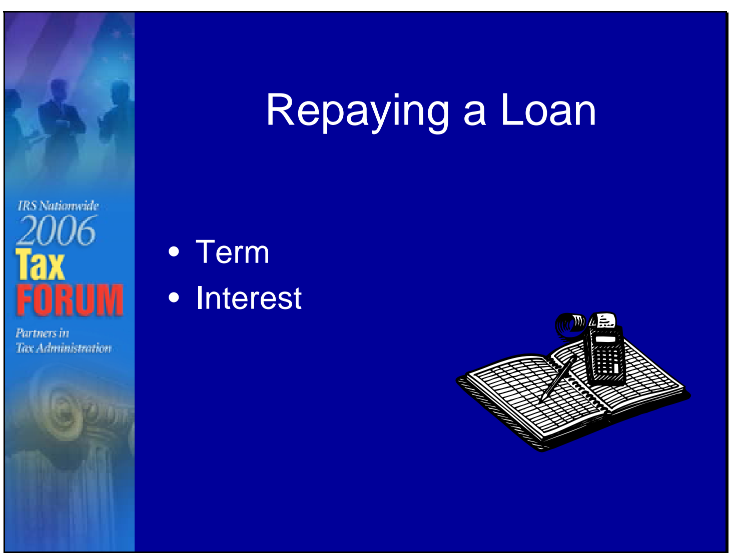

How long does the participant have to repay the loan?

Generally, repayment must be completed w/in 5 years. The repayment period can be longer than 5 years the loan is for the purchase of a main home.

Use substantially equal payments that include principal and interest – at least quarterly in frequency.

The repayment terms – length, frequency of payment and interest rate – have to be written in the plan. The plan ***has to*** use a "reasonable" rate of interest when determining loan repayments. Repayment terms must be set forth in an enforceable agreement. Not using a reasonable interest rate is a common P/T that we in the IRS (*and probably in DOL as well)* see when we examine plans. As for what constitutes a "reasonable" rate, I'd say a rate similar to what's used in the market. But that determination is made on a facts & circumstances basis.

It's possible at this point in the program that you're asking yourself, "Can the plan charge a fee for a loan?" If that's the case, good: that means you're awake and paying attention. Oh and the answer to your question is "Yes" – for example, the federal gov't version of a 401(k) plan, the Thrift Savings Plan (TSP), charges participants a $50 loan fee.

Also, in the case of military personnel, the loan can be – but doesn't have to be – suspended while the participant is in military service. Interest continues to accrue during any repayment suspension.

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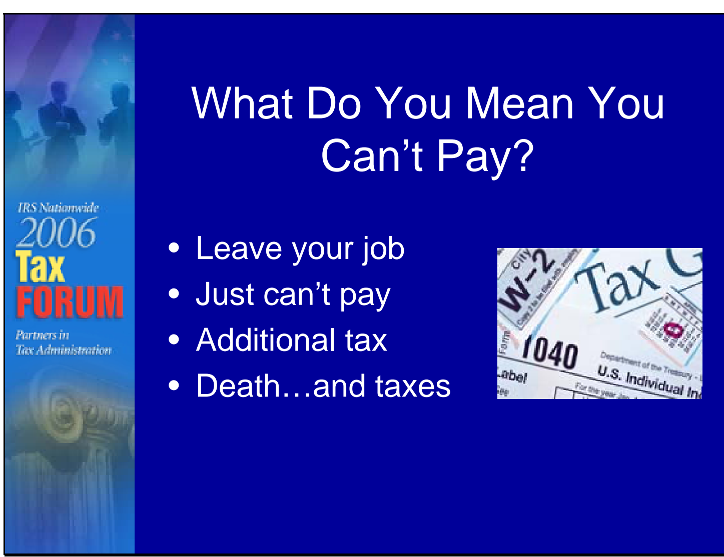

If the loan isn't repaid, it's treated as a distribution w/ the consequences of that treatment: the balance is includable in income and subject to additional tax if the participant is not yet age 59-1/2. The plan administrator needs to send the participant a Form 1099-R for the includable amount.

Let's take a look at a couple of common circumstances involving the non-repayment of loans:

First, someone has a loan and they leave the job -

Generally, the person has 30-90 days after severance to repay the balance. Otherwise, if you don't repay, the balance gets included in income.

Just can't/don't pay –

Balance gets included in income in the year payments stop.

Important: Any distributable amount – such as an unpaid loan balance – reduces what the participant would've otherwise had at retirement.

And then there's the additional tax –

There's a 10% additional tax if the participant is not yet 59-1/2. The tax is on the unpaid loan balance.

Death…and taxes –

What happens to the loan balance if, God forbid, you die while in repayment status? Answer: The balance is treated as a taxable distribution to your estate. The good news – such as it is,

considering you're dead and all – is that the estate isn't subject to the additional tax even if the participant wasn't yet 59-1/2.

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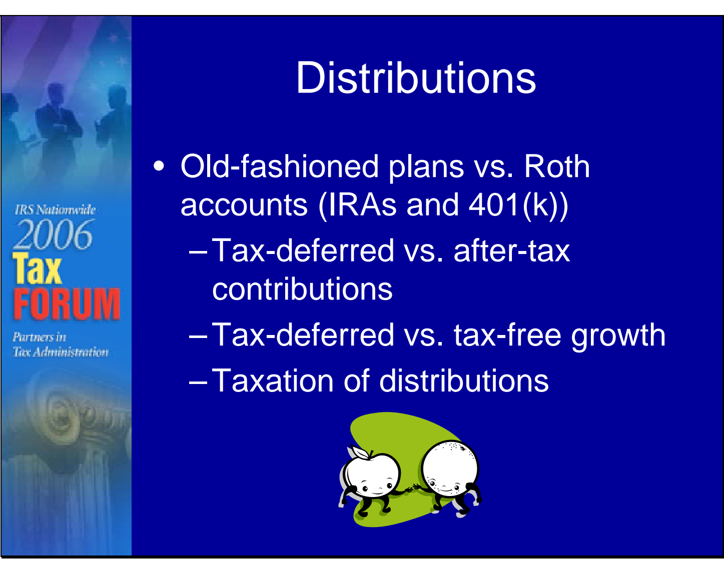

We'll do some discussion here about Roth accounts – both IRAs and the new-for-2006 Roth 401(k) accounts.
Also, if you're looking for more info on Roth 401(k) accounts, be sure to check out our presentation on "Roth 401(k) and Tips," where you will learn the Who, What, Where, When and Why of the "new-for-2006" Roth 401(k) accounts. Highlights include: Who can contribute, What plans allow these contributions, Where do you go for more information, When can you take distributions and Why would these contributions work better for some people vs. others.

Roth contributions are after-tax dollars. Whether in a Roth IRA or k account, the monies grow tax-free. Subsequent qualified distributions are also tax-free. Also, Roth k accounts ***are subject to*** the RMD rules. On the other foot, Roth IRAs ***are not subject to*** RMD rules (while the IRA owner is alive). *Check out our Roth 401(k) presentation for more info on these exciting new savings vehicles.*

But the balance of our discussion focuses on old-fashioned retirement vehicles – i.e., non-Roth accounts.
Early distributions from these "regular" plans may be subject to 20% withholding tax and maybe a 10% additional tax.
Certain **early** distributions are exempt from the 20% withholding tax:
Direct rollovers (to other IRAs or qualified plans) including those made by a surviving spouse; and
Hardship distributions.
Note: A "direct" rollover is one where the amount is paid directly to the receiving IRA/plan. Therefore, unless you want to use personal funds to make up the amount withheld, do a direct transfer from the plan to the IRA or other eligible plan.

There are other, esoteric early distributions that are exempt from withholding as well.
Certain early distributions are exempt from the 10% additional tax:
Substantially equal periodic payments after separation from service (See IRC 72(t) for more details on how to determine "substantially equal periodic payments.");
Disability;
Death of the participant/contract holder;
After age 55 and severance from service;
QDROs; and

Payment of certain large medical expenses.

There are other, esoteric distributions that are exempt from the additional tax as well.

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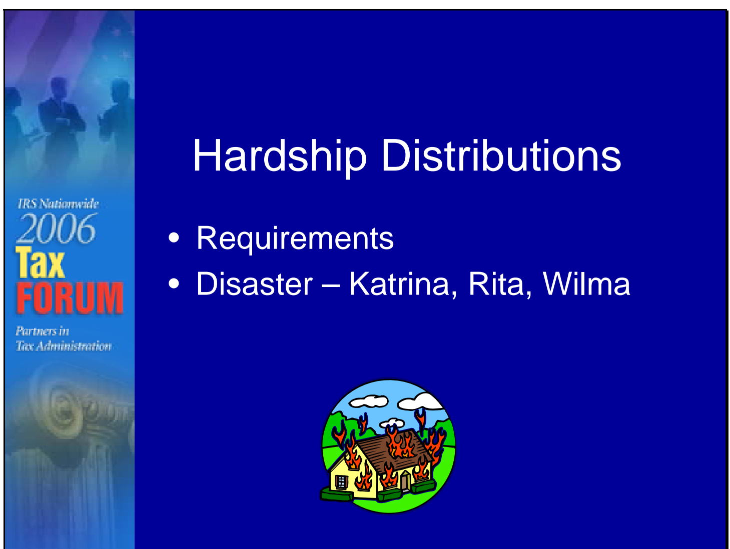

First, the law and IRS guidance spell out the criteria used in order to determine whether there's a hardship. However, *if the plan provides for such distributions*, then it must provide the *specific* criteria used to make the determination of hardship.

General legal requirements in a 401(k) plan:
There must be "immediate and heavy financial need"
Deemed "immediate and heavy" for:
Medical expenses;
Purchase of principal residence;
Tuition and related education expenses;
To prevent eviction;
Funeral expenses; and
Repairing casualty damage to your house.

Remember, the plan has to provide for these kinds of distributions. For example, the plan may provide hardship distributions in the case of medical and home-related expenses but it might not provide for distributions to pay for tuition or funeral expenses. BTW: Approvals for these applications cannot discriminate between low-paid and high-paid employees.

2005 Hurricane Relief:
Time-frame: Distributions between August 25, 2005 and December 31, 2006;
Amount: Up to $100,000;

No 10% additional tax;

Included in income but spread over 3 years.

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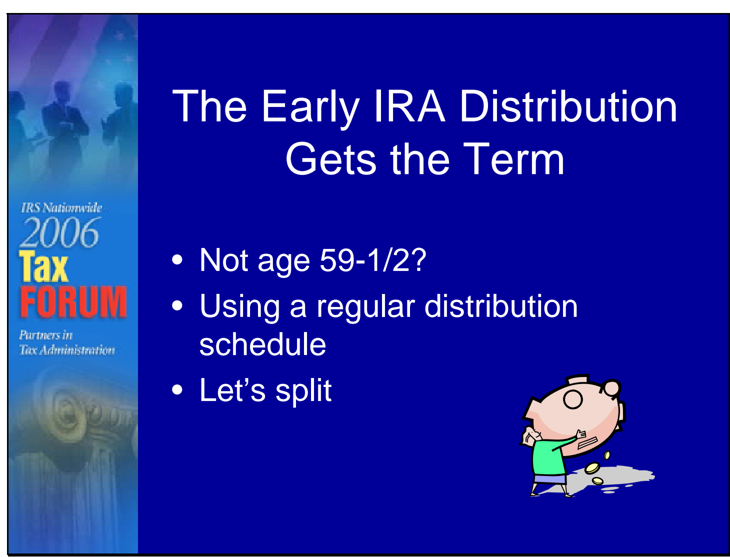

These are retirement plans we're talking about, not regular savings accounts. As such, retirement plan assets receive tax-favored status. If these assets are used prior to retirement age, the purpose of the tax-favored status is lost.

These Early Distributions – unlike loans – are included in income.
But – depending on their purpose – they may/may not be subject to a 10% additional tax.

For IRAs, there are exceptions to the 10% tax:
Unemployed for at least 12 weeks and use the money to purchase health insurance.
Use the money to pay for unreimbursed medical expenses that exceed 7.5% of AGI (this exception is also available to k plans).
College tuition for you or a family member.
First-time home buyers can use up to $10,000 to pay for house-related expenses.

If you're not yet age 59-1/2 and take a distribution, you can also avoid the 10% tax by using a regular schedule of periodic payments –
Must be based on the life/lives of the account holder(s).
Various ways to determine the amount – e.g., use original account balance/life table to determine all payments or re-determine the balance/life expectancy each year.

Let's Split –
Let's say you're not yet 59-1/2 and you'd like to take some distributions from your IRA but you don't want to have all of the IRA distributed. To avoid the tax, you can split your IRA. Figure out how much you think you'll need, and put that in one IRA – this will be the basis of your payment plan. Keep the rest in the original IRA, where it can continue to grow-tax-deferred.

Question: Anyone here familiar with the Tax Court (www.ustaxcourt.gov) case *Keith Lamar Jones v. Commissioner of Internal Revenue*? Considering our topic here is Distributions from a retirement plan, I think it's important to talk about it for a bit.

In this case, Mr. Jones quit his job and later returned to school to earn his PhD. He took out some $30,000 from his 401(k) account at his former employer to pay for school expenses and to buy his first home. Mr. Jones declared the money as income and paid the normal tax on it. Mr. Jones was audited and the IRS determined that – since Mr. Jones was not yet 59-1/2 – he also owed the 10% early distribution tax. While the Tax Court sympathized w/ Mr. Jones, it concluded that penalty-free withdrawals for higher-education and first-time home-buying expenses are only available to IRAs, not 401(k) plans.

So…to do it right – i.e., w/o the 10% additional tax – Mr. Jones should have made a direct rollover from the 401(k) account to an IRA. Once in the IRA, the funds for his purposes could've been withdrawn w/o the additional tax.
Be careful.

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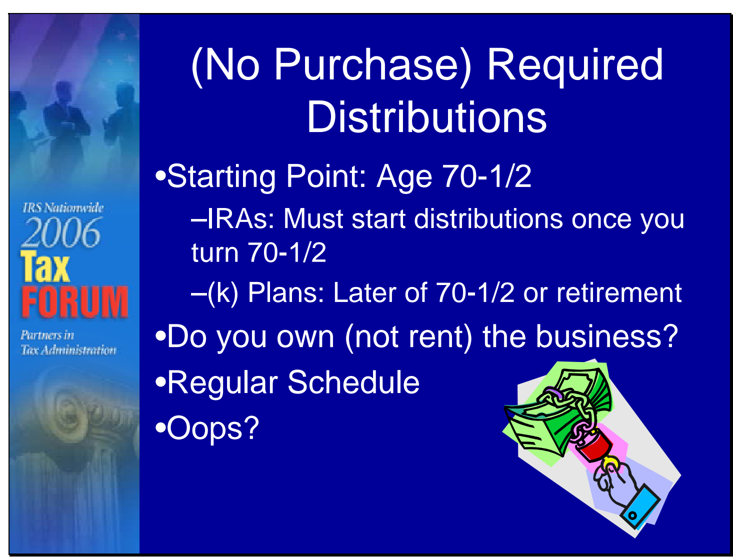

Why does the government say you must take distributions?

These are retirement plans we're talking about here, not estate planning vehicles.

For the old-fashioned plans (i.e., non-Roth accounts), the contributions, salary deferrals and earnings haven't been taxed. On the other hand, Roth accounts consist of after-tax contributions.

Accordingly, the gov't doesn't want that non-Roth money to "escape" taxation by remaining in tax-deferred accounts in perpetuity.

For our purposes, these RMDs mean:
The entire amount or
A series of payments based on life expectancy (or expectancies if there's also a designated beneficiary) or some shorter period.

Starting point of age 70-1/2 –
For IRAs, you must receive distributions starting at this age.
Whereas for k plans, the *legally* required *latest* starting point is the later of retirement or 70-1/2.
However, a plan can require distributions at 70-1/2 even if the participant isn't retired.
Because of the difference between IRAs and k plans, one option for working IRA holders age 70-1/2 is rolling their IRA into their k plan (provided that the k plan accepts such rollovers). That way, they can continue to work w/o having to take the RMDs from their IRA.

Now, let's consider someone w/ a Roth 401(k) account (which is subject to RMD rules) – who hasn't hit the RMD deadline. That person can roll over those Roth 401(k) funds into a Roth IRA, which is not subject to the RMD rules. That's clear isn't it?

Business Owners –

If you own (more than 5% of the business) you must start RMDs by age 70-1/2 regardless of whether you're still working or whether the money is in an IRA or k plan.

Regular Schedule –

Is the account just in your name or do you have a co-holder? The RMD is based on the life expectancy/ies of the account holder(s).

Use the tables in the regulations under Code § 401(a)(9).

Penalties –

If you snooze, you lose. Penalty = ½ of the difference between RMD and what was actually taken. Don't let the gov't take money from your retirement plan via this penalty, which happens each year you don't take the RMD.

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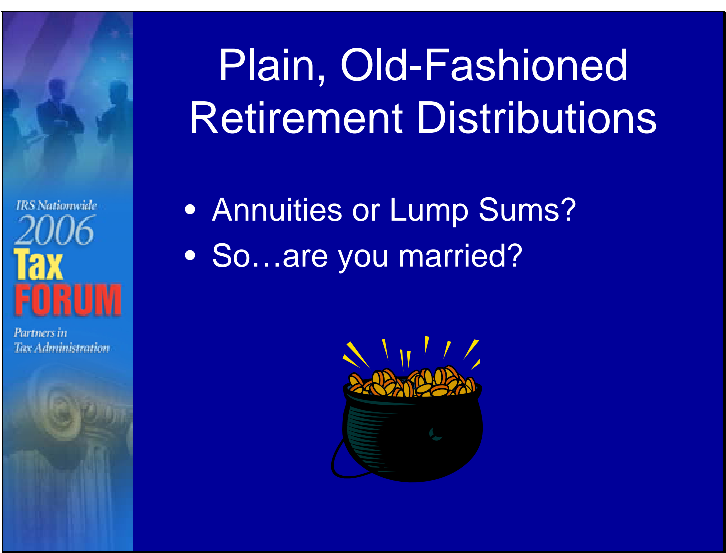

According to a 2005 Congressional Research Service report, 84% of lump sum recipients rolled over all or some part of the distribution into personal savings.

44% rolled over all of it.

40% saved a portion using IRAs, stocks, mutual funds, property, etc.

According to the same study, a 25-year-old today can expect to have seven different employers by the time they reach age 65. This will lead to plenty of opportunities to receive distributions and roll them over…or to spend them right away and lose the All-Encompassing Power of Compound Interest.

Annuities or Lump Sums –

Annuities come in plenty of flavors:

There are ones w/ a guaranteed minimum number of payments where if death happens before the minimum is reached, the value of the remainder goes to the estate.

Survivor annuities: for example, where the spouse receives a survivor annuity of some % (common %s include 50, 75 and 100) of the original annuity.

Lump Sums: Avoid current taxation by rolling some or all of it into an IRA.

So…are you married?

Married participants –

The law requires some plans to obtain spousal consent before distributing lump sums.

This – lack of spousal consent for lump sums – is a common problem that we see in our correction programs.

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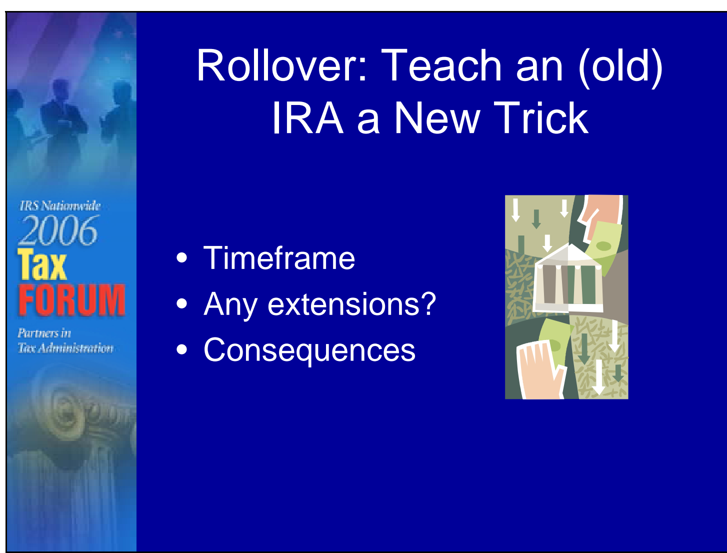

Here, we're talking about when a living, breathing plan participant leaves service and receives a distribution.

Amounts over $1,000 need to have an affirmative election – "I want it all and I want it now" – to get a lump sum.

Otherwise, the plan must transfer the amount to an IRA. Also, the participant must be notified that they can transfer such amount into an IRA that they set up or into an eligible employer plan.

Remember: As we discussed before, unless you make a **direct** rollover, the distribution amount is subject to 20% withholding. So make it direct if you want to avoid the hassle.

Timeframe:
To remain tax-free, rollovers to an IRA from a qualified plan must be completed w/in 60 days.

And as long as we're talking about timeframes, if you don't make a **direct** rollover, you can take the 80% amount (remember: indirect transfers are subject to 20% withholding), rollover that amount and "gross up" the distribution by adding the 20% from personal funds to accomplish a 100% rollover. Then, when you file your income tax return for that year, you'll get a refund of the 20% that was withheld (assuming, of course, that you've already paid "enough" taxes for the year.).

Extensions:
We got a lot of requests – at least in the last couple of years – from folks asking for a waiver of this 60-day deadline. Because the user fees went up this year – in some cases, by a good deal – I imagine we'll see fewer such requests this year.

Consequences:

You’re looking at including the non-rolled over portion in income. And, as we’ve discussed, there’s also the possibility of a 10% additional tax for folks who aren’t yet 59-1/2.

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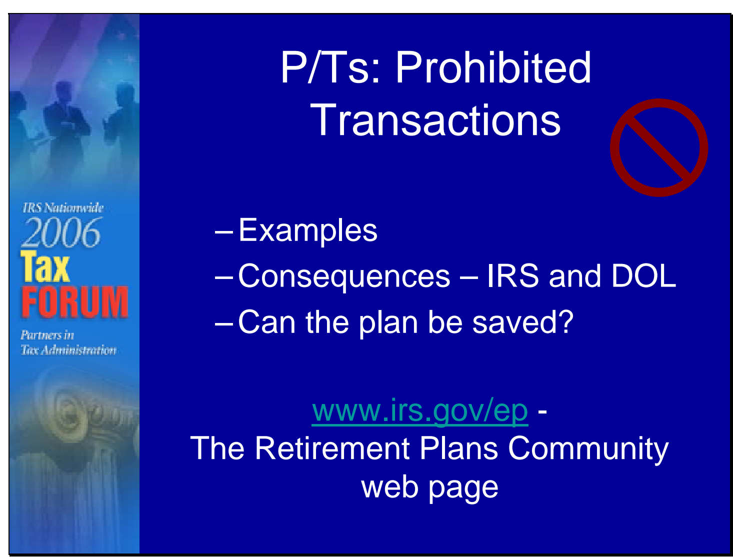

Prohibited Transactions

Prohibited transactions are transactions between the plan and a disqualified person that are prohibited by law. If you are a disqualified person who takes part in a prohibited transaction, you must pay a tax.

Prohibited transactions generally include the following transactions:

A transfer of plan income or assets to, or use of them by or for the benefit of, a disqualified person.

Any act of a fiduciary using plan income or assets in their own self-interest.

The receipt of consideration by a fiduciary for their own account from any party dealing with the plan in a transaction that involves plan income or assets.

Any of the following acts between the plan and a disqualified person:

Selling, exchanging, or leasing property.

Lending money or extending credit.

Furnishing goods, services, or facilities.

Certain transactions are exempt from being treated as prohibited transactions. For example, a prohibited transaction does not take place if you are a disqualified person and receive any benefit to which you are entitled as a plan participant or beneficiary. However, the benefit must be figured and paid under the same terms as for all other participants and beneficiaries.

Disqualified person. You are a disqualified person if you are any of the following: ***(Note: Just hit those items that you can/want to – tell the audience that this isn't a complete list.)***

A fiduciary of the plan.

A person providing services to the plan.

An employer, any of whose employees are covered by the plan.

An employee organization, any of whose members are covered by the plan.

Any direct or indirect owner of 50% or more of any of the following:

The combined voting power of all classes of stock entitled to vote, or the total value of shares of all classes of stock of a corporation that is an employer or employee organization described in (3) or (4).

The capital interest or profits interest of a partnership that is an employer or employee organization described in (3) or (4).

The beneficial interest of a trust or unincorporated enterprise that is an employer or an employee organization described in (3) or (4).

A member of the family of any individual described in (1), (2), (3), or (5). (A member of a family is the spouse, ancestor, lineal descendant, or any spouse of a lineal descendant.)

A corporation, partnership, trust, or estate of which (or in which) any direct or indirect owner described in (1) through (5) holds 50% or more of any of the following.

The combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation.

The capital interest or profits interest of a partnership.

The beneficial interest of a trust or estate.

An officer, director (or an individual having powers or responsibilities similar to those of officers or directors), a 10% or more shareholder, or highly compensated employee (earning 10% or more of the yearly wages of an employer) of a person described in (3), (4), (5), or (7).

A 10% or more (in capital or profits) partner or joint venturer of a person described in (3), (4), (5), or (7).

Any disqualified person, as described in (1) through (9) above, who is a disqualified person with respect to any plan to which a section 501(c)(22) trust is permitted to make payments under section 4223 of ERISA.

Tax on Prohibited Transactions

(Note: Just hit those items that you can/want to – tell the audience that this isn't a complete list.)

The initial tax on a prohibited transaction is 15% of the amount involved for each year (or part of a year) in the taxable period. If the transaction is not corrected within the taxable period, an additional tax of 100% of the amount involved is imposed.

Both taxes are payable by any disqualified person who participated in the transaction (other than a fiduciary acting only as such). If more than one person takes part in the transaction, each person can be jointly and severally liable for the entire tax.

The amount involved in a prohibited transaction is the greater of the following amounts.

The money and fair market value of any property given.

The money and fair market value of any property received.

If services are performed, the amount involved is any excess compensation given or received.

The taxable period starts on the transaction date and ends on the earliest of the following days.

The day the IRS mails a notice of deficiency for the tax.

The day the IRS assesses the tax.

The day the correction of the transaction is completed.

Pay the 15% tax with Form 5330.

Correcting a prohibited transaction. If you are a disqualified person who participated in a prohibited transaction, you can avoid the 100% tax by correcting the transaction as soon as possible. Correcting the transaction means undoing it as much as you can without putting the plan in a worse financial position than if you had acted under the highest fiduciary standards.

If the prohibited transaction is not corrected during the taxable period, you usually have an additional 90 days after the day the IRS mails a notice of deficiency for the 100% tax to correct the transaction. This correction period (the taxable period plus the 90 days) can be extended if either of the following occurs.

The IRS grants reasonable time needed to correct the transaction.
You petition the Tax Court.
If you correct the transaction within this period, the IRS will abate, credit, or refund the 100% tax.

Conclusion:
We've now reviewed a lot of material on Accessing Money in a Retirement Plan. At this point, I'd be happy to take your questions. If there's something I didn't make clear or didn't address or anything you'd like to bring up, please feel free to ask me.
And when we're done, remember that we – the Employee Plans division – have a booth in the Exhibit Hall where we have plenty of free – yes, I said "free" – retirement-related pubs and other goodies.
Until we meet again, I bid you a fond adieu!

Again, remember our presentation on "Roth 401(k) and Tips," where you will learn the Who, What, Where, When and Why of the "new-for-2006" Roth 401(k) accounts.