

Don't Take Money Out Of Your Retirement Plan....But If You Need To, Here's How

By Laif Meidell – American Retirement Planners

www.FinancialHealth.com

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Every once in a while I get a call from a client or a friend who is having a “financial emergency.” Like most people, they have been faithfully putting a portion of each paycheck into their employer's retirement plan (such as a 401(k), 403(b), or 457 Plan) and, as a result, it is usually their largest investment asset. Although not as large as their assets in their employer's retirement plan, they typically also have a few dollars saved in an IRA as well. After turning over every stone for money, they are now wondering what the IRS will do to them if they take money from their IRAs or their retirement plan and if there are any loop holes they can take advantage of.

I have found that investing is a lot like life. We start out on a given path with a specific destination in mind, such as saving for retirement. However, sometimes along the way we are forced to change our financial route due to obstacles that get into our path. In that spirit, the following five suggestions are meant to help you with those rare financial course corrections that may happen in life. Please consider them as a last resort, and not as a means to potentially purchase that new toy you have been dying to have.

If you are less than 59 ½, taking a distribution from your IRA, Roth IRA, or most profit sharing plans can be the most expensive way of getting money. Not only will you have to pay tax on what you take out, but you will likely also have to pay a 10 percent penalty on the full distribution amount. Depending on your tax bracket I have seen instances where it is possible to lose as much as 40 percent of your money in taxes and penalties. If you are still working and over 59 ½ you can usually take money from your 401(k), especially if your plan allows hardship withdrawal and your reason for distribution qualifies. You will still have to pay taxes on the distribution, but you may be able to avoid the 10 percent penalty.

Roth IRAs are great when it come to taking distributions. If you have owned a Roth IRA for more than 5 years and are over 59 ½, your distributions will be tax free and penalty free. If you have had the Roth IRA for less than five years and are over 59 ½ you will only be able to take out the dollars you have contributed penalty free. If you are less than 59 ½ the rules are not as clear cut so you will want to consult a professional.

Before just taking your money out and paying the penalties and taxes, consider taking a loan from your 401(k), profit sharing, or other employer qualified plan. Not every plan may have loan provisions but it has been my experience that today most plans do. In general, you will not be able to take a loan for more than 50% of your plan's vested balance. At present, the maximum loan amount that you can take out from your group qualified plan is \$50,000, so you would need a vested balance of at least \$100,000 before you can borrow that much¹. Many people seem to like qualified plan loans, because they like the idea that the interest payments that they are

¹ Please note that the retirement plan offered by your employer may have set more stringent guidelines and lower maximum loan amounts.

making toward the loan is essentially being added to their retirement plan assets. However, your loan must be repaid in no more than five years.

You cannot take a loan from an IRA. Anytime you take dollars from your IRA, and don't repay it in full within 60 days, it's considered a distribution, and therefore taxed and or penalized accordingly. However, the 60-day rule does allow an IRA owner to take a distribution, within a 12 month period, and then roll it back into the IRA within the 60 day period tax-free. It is kind of like taking a short term loan, but I have seen people fail to redeposit the money back into the IRA within the 60 days and then suffer the consequences of taxes and penalties. Don't let that happen to you.

Some of you may have made contributions to your IRA that were non-deductible on your tax return, so in the IRS' eyes you have already paid taxes on this money. What you can do is to transfer all of your gains and any pre-tax dollars that you had contributed into your IRA into your qualified retirement plan at work. This leaves you with just your after tax (i.e., non deductible) contributions sitting in your IRA. Now cash out your IRA tax-free, and penalty free if you are more than 59 ½.

If you are less than 59 ½ the following exceptions to the 10 percent penalty rule may apply to you. If you need to start taking an income stream from your IRA and you are less than 59 1/2, you can take a penalty-free "series of substantially equal periodic payments." (commonly called a 72(t) election after the IRS Code section 72(t)) This is a stream of annual, quarterly, or monthly payments that you must receive until you reach 59 ½ or for 5 years, whichever is longer. This can allow you to have an early retirement and use your IRAs for income. If you need a large lump sum of money at once and want to be creative, consider refinancing the house or other assets with excess equity (with a bank), then use a 72(t) distribution election, as described above, from your IRA to make the mortgage payments. However, as indicated above, once this option is elected you will not be able to change it until you turn 59 ½ or have received payments for at least 5 years, which ever is greater. Before making this decision, I suggest that you seek guidance and assistance from a qualified CPA or financial advisor.

You may also avoid the 10 percent penalty on your IRA distribution if the money is used for the following expenses: the first-time home purchase for yourself or a family member; to pay for qualified educational expenses, health insurance premiums if you have been unemployed a long time, for substantial medical expenses, or in case of disability you can qualify for the disability exception upon proof that a disability is present that prevents you from engaging in "substantial gainful activity."

Again, there are times when taking money from your retirement plan may be necessary for your own financial health. Weigh the pros and cons of your decision before you make it, and remember to consider the long term affects of your decision such as how many more years you may need to work to make up the difference.