THG Thoughts

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Withdrawals from retirement savings: Tough rules may change

In response to the economic downturn that has affected the retirement portfolios of millions of individuals across the country, Congress has been considering a variety of alternatives to offer relief to those who face financial emergencies and need immediate access to their funds. Two of the most significant proposals that have been recommended include: (1) significant broadening of the suspension of the 10 percent penalty tax on early withdrawals from IRAs and defined contribution plans, and (2) extending the temporary suspension of the penalty tax imposed on individuals age 70 1/2 or older who do not take required minimum distributions (RMDs) from certain retirement plans.

Early withdrawal penalty

To discourage individuals from using money set aside in retirement accounts for expenses incurred outside of retirement, a 10 percent tax is imposed on the amount that is withdrawn, in addition to this amount being included in the individual's gross income and subject to federal (and often, state) income tax. The 10 percent penalty will not apply to distributions made in the following circumstances:

- After the individual has reached age 59 1/2;
- The distribution is made to an individual who is a beneficiary of a deceased IRA owner;
- The individual is disabled;
- For higher education expenses (from IRAs only);
- The distributions are made as part of substantially equal payments over the account holder's life expectancy;
- The individual retires after age 55;
- For unreimbursed medical expenses exceeding 7.5 percent of the individual's adjusted gross income (AGI);
- For medical insurance premiums in the case of unemployment;
- To buy, build, or rebuild a first home (from IRAs only, and subject to a $10,000 withdrawal limit); and
- If the individual is a reservist called to active duty after September 11, 2001.

Caution: The extent to which a withdrawal may be made from an employer-sponsored qualified retirement plan, even with respect to amounts that you contributed, depends upon what is allowed under the written plan itself. Some plans only allow you to withdraw after retirement. Others allow withdrawals for "hardships," which may include medical expenses or other financial crisis. Still other withdrawals, such as withdrawals for higher education or a first home purchase, are never allowed under IRS rules from an employer-run. The 10 percent penalty and, for that matter, the underlying taxable income generated from a withdrawal, do not apply if the funds are properly rolled over within a 60-day period from an employer-sponsored plan to an IRA or from one qualified plan or IRA to