Know your rights on retirement

Or Any Job Termination

Several methods to avoid penalty for withdrawal

Dan Gallagher

Investing

Recently, numerous employees were terminated from a large manufacturer and were unable to find new employment.

Needing cash for their obligations, many under age 59 and a half took money from their retirement plans and paid, or soon will pay, the well-known 10 percent penalty.

What's the surprise? They paid the penalty needlessly!

Most of us are aware that loans from tax-qualified plans are immune to both income tax and the 10 percent penalty on withdrawals before age 59 and a half, if they're repaid in five years.

Certain loans qualify for a longer repayment period. Hardship withdrawals, as distinct from loans, are another well-known exception and not penalized.

Effective March 20, 1989, however, new IRS rules prescribed three ways to avoid the penalty.

If retirement plan assets are rolled into an annuity funding an IRA and a lifelong income option is then selected, the penalty is waived regardless of age.

This method has been permitted for both qualified (deductible, tax-deferred) plans and non-qualified (non-deductible, tax-deferred) plans, since January 1, 1987.

However, it required the annuity product as the investment because the code was unclear in its treatment of other types of investments.

Many people do not like this method because it precludes subsequent recovery of the principal in lump form.

It also commits the annuitant to taking the income for life even if the income later becomes unneeded, say because of new employment.

– New Rules

Now, if plan assets are rolled into an IRA funded with any investment, including an annuity, one no longer needs to sacrifice principal or commit to lifelong income to avoid the penalty for early withdrawals. General rules apply:

a) An IRA rollover (which usually requires employment termination) is necessary unless the employer plan permits on-demand withdrawals;

b) You must make "substantially equal" withdrawals which essentially mimic an annuity payout.

Withdrawals must be exactly the amount prescribed by your choice of three calculation methods, described below, all of which use morality estimates;

c) Calculations must apply to an entire account balance. However, you may split plan distributions into two IRAs, then draw from only one;

d) You cannot switch the method of calculating withdrawals once begun;

e) If you do not take exactly the withdrawal prescribed, Uncle Sam wants a prorated recapture of the penalty (plus interest) on the difference!

This can occur if you have an investment loss or take the wrong amount;

f) You must make these withdrawals, needed or not, until the later of age 59 and a half or five years from when you started them;

g) You must use IRS Forms 5329 and W4-P to claim this penalty exemption.

The specific calculation methods to choose from are:

Life Expectancy: With this method, you multiply the account balance by a mortality factor in the tax code.

The factor changes with age, so you must recalculate each year and you withdraw different amounts each year.

Amortization: The second new method is to amortize the account balance over your expected lifespan, as defined in the code, at an interest rate which the IRS has defines as reasonable.

There are no recalculations of expected lifespan or interest, so withdrawals are the same each year.

Mortality Table: The third new method is to divide the account balance by what the IRS defines as a "reasonable annuity factor derived using a reasonable interest rate and mortality assumption".

What a mouth full! Essentially, the IRS lets you pick annuity factors available through pension actuaries and insurers; but you must be careful that the factor conforms to the IRS's complicated definition of "reasonable".

Annual recalculations are not made; withdrawals are the same each year.

– Reasonable and Fair

Ah huh ... Sure! One cannot help but wonder what actuarial planet the writers of such rules came from!

In trying to make rules which bring reasonableness to the system, the IRS seems to create pitfalls into which taxpayers will unknowingly fall (and end up paying penalties anyway)!

Nevertheless, for many who retire or are terminated, the opportunity to avoid penalty on desperately needed income is a Godsend.

Because of the potential liability, however, employers will not make these calculations for departing employees.

My suggestion: Find an advisor who a) will counsel you; b) is competent and c) will guarantee, in writing, to pay any fines for negligence.

Dan Gallagher is a financial advisor at Gallagher and Associates on the Peninsula.