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Retirement Savings Accounts: Early Withdrawals and Required Distributions

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Retirement Savings Accounts: Early Withdrawals and Required Distributions

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. It also briefly describes changes to these laws proposed in the Administration's FY2004 budget.

In 2000, 61 million Americans owned an individual retirement account (IRA) or participated in an employer-sponsored retirement savings plan. The Office of Management and Budget (OMB) has estimated that the tax revenue foregone through the exclusion of retirement savings plan contributions and investment earnings from taxable income will total $463 billion from 2004 through 2008, making it the second largest federal tax expenditure. 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, Congress has required distributions from accounts that are funded with tax-deductible contributions to begin when the account owner reaches age 70½. 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 pre-retirement withdrawals from retirement savings accounts, the Internal Revenue Code (I.R.C.) imposes a 10% penalty on early withdrawals, 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, contributions to a Roth IRA can be withdrawn at any time without being subject to additional income taxes or an early withdrawal penalty.

The President's budget proposal for FY2004 would establish *Lifetime Savings Accounts* (LSAs) that could be used for any type of saving and from which withdrawals could be made at any time, and *Retirement Savings Accounts* (RSAs) that could be used for retirement saving. Roth IRAs would become RSAs. Traditional IRAs could be converted to RSAs, with income tax due on the converted amount. Beginning in 2004, several kinds of employer-sponsored retirement plans would be consolidated into *Employer Retirement Savings Accounts* (ERSAs). This report will be updated in the event of further legislative developments.

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Retirement Savings Accounts: Early Withdrawals and Required Distributions

In the interest of encouraging workers to save for retirement, Congress has authorized the creation of 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 plans or to take tax-free distributions from the plans after they retire. This CRS Report summarizes the provisions of federal law that govern the taxes applicable to pre-retirement distributions from retirement accounts and the situations in which distributions must be taken in order to avoid a tax penalty. It also briefly describes changes to these laws proposed in the Administration's FY2004 budget.

In 2000, 61 million Americans owned an individual retirement account (IRA) or participated in an employer-sponsored retirement savings plan.[1] According to the Office of Management and Budget (OMB), the net exclusion of retirement savings plan contributions and investment earnings from taxable income is the second largest tax expenditure in the federal budget. It is larger than the deduction for interest on home mortgages, but smaller than employer contributions for health insurance. If deductions and exclusions for traditional pension plans are included, pensions and retirement savings plans together comprise the largest tax expenditure in the federal budget.[2]

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 U.S. General Accounting Office has noted, "these limits exist to prevent partial public subsidies of excessively large retirement benefits through tax preferences."[3] 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, Congress has required distributions from

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[1] Of this number, 47.1 million were workers between the ages of 25 and 64. (See CRS Report RL30922, *Retirement Savings and Household Wealth in 2000* by Patrick Purcell.)

[2] The OMB has estimated that the tax expenditure for retirement savings plans will total $463.1 billion over the 5 years from 2004 to 2008. The deductions and exclusions for traditional pensions will result in another $340.6 billion in foregone revenue. See *Analytical Perspectives, Budget of the U.S. Government*, Fiscal Year 2004, U.S. Government Printing Office, Washington DC , 2003, Table 6-1, page 104.

[3] U.S. General Accounting Office, *PRIVATE PENSIONS: Issues of Coverage and Increasing Contribution Limits for Defined Contribution Plans*, GAO-01-846, September 2001, p. 1.

retirement accounts that are funded with tax-deductible contributions to begin when the account owner reaches age 70½ . Taxpayers who do not take these "required minimum distributions" are subject to a tax penalty. If these distributions were not required, the temporary tax deferral that Congress created to encourage retirement saving would become a permanent tax exemption for those who are wealthy enough that they do not need their retirement savings to support themselves. 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 pre-retirement withdrawals from retirement savings accounts, the Internal Revenue Code (I.R.C.) imposes a 10% excise 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.

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). Investment earnings accrue on a tax-deferred basis, and when distributions are taken from the plan, they are taxed as ordinary income.[4] 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. 106-17) authorized a "Roth 401(k)" beginning in 2006. Like the Roth IRA, all contributions to these plans will be made on an after-tax basis, and qualified distributions from the plans will be tax-free.

Contribution Rules: Putting Money into a Retirement Account

Contribution Rules for Traditional IRAs. In 2003, a worker can make a tax-deductible contribution of $3,000 (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 $500. For an unmarried worker who is covered

[4] Personal income is classified as either "ordinary income" or "capital gains." In 2003, the top marginal tax rate on ordinary income is 38.6%. The top rate on capital gains is 20%.

by an employer-sponsored retirement plan, the deduction phases out between $40,000 and $50,000 of modified adjusted gross income.[5] For a married worker who is covered by a plan at work, the maximum deductible contribution phases out between $60,000 and $70,000 of modified AGI.[6] 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 $150,000 and $160,000 of modified AGI.

If an individual is not eligible to make a *deductible* contribution to a traditional IRA, he or she may be eligible to make a *nondeductible* contribution. In that case, a portion of each future distribution will represent a return of the account owner's nondeductible contributions, which will not be included in the taxpayer's taxable income. The sum of these after-tax contributions is called the account "basis." Assuming that the account balance exceeds the sum of all nondeductible contributions (i.e., the account basis), a portion of each distribution will represent investment earnings, which *will be* included in taxable income. There is no upper income limit for people who can make nondeductible contributions to a traditional IRA, but contributions cannot be made after age 70½, the age at which federal law requires distributions from a traditional IRA to begin. The required distributions must be sufficient to fully distribute the account over the expected life of the account owner or the joint life expectancy of the owner and his or her designated beneficiary.

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 contribute to a Roth IRA. For single tax filers, the maximum permissible contribution to a Roth IRA phases out from $3,000 to $0 for those with modified adjusted gross income between $95,000 and $110,000. For married couples filing jointly, the maximum permissible contribution to a Roth IRA phases out between $150,000 and $160,000 of annual income.[7] 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 $3,000 in 2003 and 2004 (or $3,500 for individuals age 50 and over). The contribution limit is scheduled

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[5] 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.

[6] The phase-out range for single filers will increase to $45,000-$55,000 in 2004 and to $50,000-$60,000 in 2005. For married couples, the phase-out range increases to $65,000-$75,000 in 2004 and increases yearly until it reaches $80,000 to $100,000 in 2007.

[7] The income limit for converting a traditional IRA to a Roth IRA is lower. 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.

to increase in stages to $5,000 in 2008, plus an additional $1,000 annually for individuals age 50 or older.

Withdrawals from Roth IRAs. 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,[8] and account earnings last. Distributions that exceed the account basis are taxable unless they are *qualified distributions*. These distributions also may be subject to a l0% excise tax if made before age 59½. All qualified distributions from a Roth IRA are tax-free. ("Qualified distributions" are discussed on page 15.)

If a traditional IRA has been funded all 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. In contrast, 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.

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. Taxpayers with AGI of $100,000 or less (except those who are married and filing separately) can convert a traditional IRA to a Roth IRA. 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 5 years – or until the account owner reaches age 59½, if earlier – or it will be subject to the 10% excise tax on early distributions. In other words, if a distribution occurs less than 5 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.

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."

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[8] A "rollover" is a deposit that came directly from another tax-qualified retirement account.

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 2003 is the lesser of $12,000 or 100% of compensation.[9] Under the terms of the *Economic Growth and Tax Relief Reconciliation Act*, the maximum deferral will increase by $1,000 per year until it reaches $15,000 in 2006, after which it will be indexed to inflation. Participants aged 50 or over can make additional "catch-up" deferrals of up to $2,000 in 2003. These catch-up deferrals will increase to $5,000 by 2006. The maximum *annual addition* to a defined contribution plan – the sum of employer and employee contributions – is the lesser of $40,000 or 100% of compensation in 2003.[10] This limit is indexed to the Consumer Price Index (CPI) in $1,000 increments. Non-profit organizations and educational institutions can establish tax-sheltered annuity plans under I.R.C. §403(b). The annual contribution limits and the minimum distribution rules for §403(b) plans are the same as for 401(k) plans. Effective on January 1, 2006, participants in 401(k) and 403(b) plans will be permitted to elect "Roth" treatment for their contributions. Such contributions will be made on an after-tax basis, but qualified distributions from the account will be tax-free. There will be no required minimum distributions from a Roth 401(k) during the employee's lifetime or that of the employee's spouse, but any other beneficiary will be subject to required minimum distributions.

State and local governments and tax-exempt organizations can establish deferred compensation arrangements under I.R.C. §457.[11] 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 $12,000 in 2003.[12] This limit will increase to $15,000 by 2006. Participants in §457 plans can make additional contributions of up to twice the standard amount in the last 3 years before normal retirement age. Participants who are 50 or older can make additional "catch-up" contributions of up to $2,000, which will increase to $5,000 by 2006. 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 $12,000 to each plan in 2003. 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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[9] 26 U.S.C. §402(g).

[10] 26 U.S.C. §415(c).

[11] Tax-exempt organizations are described in I.R.C. §501(c)(3).

[12] 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."[13] The 10% excise 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);[14]
(5) to an *employee* who has separated from service under an early retirement arrangement after reaching age 55;[15]
(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:

- 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

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[13] 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)."

[14] 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.

[15] 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.

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 2 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 will not be subject to the 10% penalty that otherwise would apply.[16] 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* 5 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 10% tax penalty otherwise applicable to early withdrawals.[17] 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

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[16] 26 U.S.C. §72(t)(2)(A)(iv).

[17] I.R.S. Notice 89-25 (March 20, 1989) and Revenue Ruling 2002-62 (October 3, 2002).

- 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 is likely to 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 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 then 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."[18]

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 expectancies 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) 5 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 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

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

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*[19] 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.[20] 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 wishes to begin taking substantially equal periodic payments in February 2003. 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.[21] If we assume an account balance of $100,000 on January 31, 2003, the first-year distribution would be **$3,378**, which is derived by dividing the account balance by the 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

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[19] 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.

[20] 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].

[21] 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.

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 **$5,804**.[22] 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 2 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 would be **$5,771**.[23] 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. As a result of the 3-year decline in the stock market that began in 2000, many people who had begun taking distributions based on the annuitization method or the amortization method have found that their retirement accounts are being depleted more quickly than they expected.[24] 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. For investors whose retirement savings have been reduced by the decline in the stock market, the smaller distributions that result will prevent their retirement accounts from being depleted as rapidly as would occur under either of the other two methods.

Revenue ruling 2002-62 also states that:

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[22] Based on an interest rate of 3.97% and a remaining life expectancy of 29.6 years.

[23] Based on an annuity factor of 17.33.

[24] The *Standard & Poor's 500* index fell 9.1% in 2000, 11.9% in 2001, and 22.1% in 2002.

- 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 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 2 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 a tax-deductible business expense, (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 assure 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.[25] 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.[26] In a traditional IRA, the required beginning date for distributions is *always* April 1 of the year after the participant

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[25] 26 U.S.C. §401(a)(9).

[26] Distributions are not required from a Roth IRA during the account owner's lifetime.

reaches age 70½. The distributions must be made over the life expectancy of the plan participant, or over the joint life expectancies 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.[27]

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 expectancies of the account owner and a designated beneficiary.)[28] 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.[29] 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, the entire account balance must be distributed within 5 years after the death of the account owner. Any amount that is to be paid to a designated beneficiary, however, 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.[30] 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.[31] 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.

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[27] 26 U.S.C. §4974.

[28] Life expectancy may be redetermined annually. (See 26 U.S.C. §401(a)(9)(D)).

[29] 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)).

[30] Any distribution required under an incidental death benefit requirement is treated as a required minimum distribution.

[31] 26 C.F.R. §1.401(a)(9)-5, published in the *Federal Register*, vol. 67 no. 4, April 17 , 2002.

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.[32] 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.

Under a bill approved by the House Ways and Means Committee in 2002 (**H.R. 5558** of the **107th** Congress), required minimum distributions, which under current law must begin on April 1 of the year after the taxpayer turns age 70½ , would have been delayed until age 73 in 2003, age 74 in 2005, and age 75 in 2007 and thereafter. This bill also would have reduced the excise tax for failure to take the required annual distribution from 50% to 25% of the amount that should have been distributed. **H.R. 315** of the **108th** Congress (Saxton) would eliminate the age at which retirees are required to begin making withdrawals from traditional individual retirement accounts. Under this proposal, retirees would never have to withdraw money from a traditional IRA or a 401(k) plan if they chose not to do so.

One reason that delaying the start of required distributions has been proposed is that the 3-year decline in the stock market has reduced the value of many IRA and 401(k) accounts. Some retirement account owners believe that the distribution requirement forces them to sell stocks at depressed prices, thus reducing their retirement savings prematurely. They would prefer the required beginning date for distributions to be pushed back to a later age or eliminated altogether. Proponents of delaying the required beginning date for distributions argue that this change in law would give retirement account owners time to recover some of their losses, assuming that the market eventually will return to its long-run average rate of growth. This, they argue, would allow them more freedom to choose the timing of distributions and make their retirement funds last longer.

Those who advocate leaving the required beginning date for distributions unchanged point out that the required distributions do not compel account owners to sell the stocks, bonds, or other assets in which the account is invested. The law requires funds to be withdrawn from the retirement account and income taxes paid on the amount withdrawn, but as one observer has noted, this requirement "doesn't force people to sell stock prematurely. . . . You can take it out in kind. You can transfer it to [a] regular brokerage account."[33] 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. Another concern is that if the age at which distributions are required were to be pushed back, 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 would be greater than a distribution beginning at age 71, because the

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[32] *Federal Register*, vol. 67 no. 74, April 17, 2002, pages 18988 to 19028.

[33] Ed Slott, CPA, as quoted by Albert Crenshaw in the *Washington Post*, August 25, 2002.

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.[34] 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. It is important to note, however, that 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 currently take distributions from their retirement accounts to supplement their retirement income, rather than because they are required 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, if their income is above the threshold for taxation, pay income taxes on those distributions.

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 completely required distributions from traditional IRAs. This would grant to some account owners free of charge a benefit that they purchased by converting their traditional IRAs to Roth IRAs and paying income taxes on the converted amounts.

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 5 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.[35]

"Hardship Distributions". The tax code permits 401(k) plans – and no other kind of tax-qualified retirement plan – to make distributions available "upon hardship

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[34] 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.

[35] Loans are not permitted from IRAs, but money in an IRA can, in effect, be "borrowed" for 60 days because the law 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)).

of the employee."[36] 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.[37] 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 6 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 code section 72(t) the distribution will not be subject to an early withdrawal penalty, even if the plan participant is under age 59½.[38]

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, or more than 5 years after the account was established, if later. 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 never subject to the early withdrawal penalty, but they are subject to regular income tax if the distribution occurs less than 5 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.

President's Budget Proposal, FY2004

The President's proposed budget for FY2004 would substantially change several aspects of individual retirement accounts and employer-sponsored retirement savings plans. The Administration's proposal would establish *Lifetime Savings Accounts* (LSAs) that could be used for any type of saving and from which withdrawals could be made at any time, and *Retirement Savings Accounts* (RSAs) that could be used for retirement saving. Roth IRAs would become RSAs. Traditional IRAs could be converted to RSAs, with income tax due on the converted amount. Traditional IRAs not converted to RSAs would no longer be permitted to accept contributions.

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[36] 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% excise tax on early distributions.

[37] 26 C.F.R. §1.401(k)-1(d).

[38] 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.

Lifetime Savings Accounts. Individuals would be permitted to contribute up to $7,500 per year, indexed to inflation, to a *Lifetime Savings Account* (LSA), even if that amount exceeded their wage income for the year.[39] No upper income limit would apply to LSA participants. Contributions would not be deductible, but investment earnings would accumulate tax-free. All distributions from the account would be tax-free, regardless of the individual's age or the purpose for which the distribution was used. As with Roth IRAs, there would be no required distributions from LSAs during the account owner's lifetime.

The annual contribution limit of $7,500 would apply to all Lifetime Savings Accounts in an individual's name; however, an individual could contribute more than $7,500 annually by contributing to the accounts of others, such as family members. For example, a family of four could contribute up to $30,000 per year by establishing an LSA in the name of each family member. Accounts opened in a child's name would become the child's property when he or she reaches age 18. An account owner also could roll over the balance in an LSA to a family member. Rollovers in excess of $11,000 would be subject to the gift tax. The $7,500 annual LSA contribution limit would be indexed for inflation.

Retirement Savings Accounts. Individuals would be permitted to contribute up to $7,500 per year from earnings to a *Retirement Savings Account* (RSA). The maximum annual contribution would be indexed to inflation. For a married couple, the maximum contribution would be the lesser of annual wage income or $15,000, also indexed to inflation. Eligibility to make contributions to an RSA would not be restricted by an upper income limit. Contributions to an RSA would be not be tax-deductible, but investment earnings would accumulate tax-free, and qualified distributions would not be taxed. Qualified distributions would include those made after age 58 or after the account owner died or became disabled. All other distributions would be nonqualified distributions. Any nonqualified distribution in excess of contributions (the account *basis*) would be subject to both the regular income tax and a 10% excise tax. Distributions would be deemed to come from basis first. There would be no required distributions from RSAs during the account owner's lifetime.

Roth IRAs would be renamed RSAs and would be subject to the rules for RSAs. Owners of traditional (deductible and nondeductible) IRAs could convert these accounts to RSAs. Any converted amounts in excess of nondeductible contributions (the account basis) would be taxed as ordinary income. If the conversion occurs before January 1, 2004, the converted amount could be included in taxable income in four yearly installments. Conversions after January 1, 2004 would be included in income in the year of the conversion. Under current law, individuals and couples with incomes in excess of $100,000 may not convert a traditional IRA to a Roth IRA. There would be no income limit on conversions of traditional IRAs to RSAs.

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[39] Balances in certain other accounts could be converted to LSAs. These include Archer Medical Savings Accounts (MSAs), Coverdell Education Savings Accounts (ESAs), and Qualified State Tuition Plans (QSTPs). Contributions to ESAs and QSTPs are made after-tax, so conversions of these accounts would not be taxable. Contributions to MSAs are not taxed, so conversions of MSAs would be subject to the income tax.

Traditional IRAs could not accept new contributions after January 1, 2004 except to receive rollovers from employer-sponsored retirement plans. Distributions from employer plans could be rolled over to an RSA by including the rollover amount (excluding basis) in gross income in the year of the conversion.

Employer Retirement Savings Accounts. Beginning in 2004, 401(k), 403(b), and governmental 457 plans would be consolidated into *Employer Retirement Savings Accounts* (ERSAs), which would be available to all employers.[40] Plan qualification rules under the Internal Revenue Code would be simplified. Other rules governing ERSAs would conform substantially to those that apply to 401(k) plans. Employees could defer wages up to $12,000 annually, increasing to $15,000 by 2006. Employees age 50 or older could defer an additional $2,000, increasing to $5,000 by 2006. The limit on "annual additions" (employee salary deferrals plus employer contributions) would be the lesser of 100% of compensation or $40,000. The tax treatment of contributions and distributions from an ERSA would be the same as the current treatment of 401(k) Plans. Employee contributions to an ERSA could be made either on a pre-tax or after-tax basis.[41] Distributions of after-tax employee contributions and qualified distributions of earnings on after-tax contributions would be tax-free. All other distributions would be subject to the income tax. The requirement for distributions beginning at age 70½ – or retirement, if later – would apply to ERSAs. Currently operating 401(k) plans would be renamed ERSAs and could continue to operate as before. Section 403(b) plans and 457 plans could be operated as ERSAs, or they could continue to be operated separately; however, if not converted to ERSAs, these plans could not accept new contributions after December 31, 2004.

Policy Issues. The Treasury Department has offered several reasons for the proposed changes to individual retirement accounts and employer-sponsored retirement plans. They state that:

- Restrictions on IRA withdrawals and the additional tax on early IRA distributions discourage many taxpayers from making contributions.

- Because deductible IRAs, nondeductible IRAs, and Roth IRAs are each subject to different eligibility, contribution, and withdrawal rules, taxpayers must initially determine and continually re-evaluate their eligibility for each plan.

- Currently, penalty-free withdrawals are allowed for several qualified expenses not related to retirement, which weakens the focus on retirement saving.

- Complex rules impose costs on employers, participants, and the government and discourage many employers from offering a plan.

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[40] The consolidation would also include Savings Incentive Match Plans for Employees (SIMPLE plans) and Simplified Employee Pension (SEP) plans.

[41] Under current law, after-tax ("Roth") treatment of 401(k) deferrals can begin in 2006.

- Reducing complexity in the employer plan area would encourage additional coverage and retirement saving.

Critics say that relatively few workers would benefit from higher contribution limits, and that most would be higher-paid workers. For example, a 2001 General Accounting Office study estimated that 8% of participants in defined contribution plans would benefit directly from an increase in contribution limits.[42] (The GAO noted that higher contribution limits could indirectly benefit low- and moderate-earners if employers formed new plans, expanded coverage in existing plans, or increased their contributions for these workers.) A 2000 Treasury Department study showed that only 4% of eligible workers made the maximum IRA contribution in 1995.[43] Surveys of small employers suggest that employees' preference for current wages and the uncertainty of revenues are greater obstacles to employer sponsorship of retirement plans than either government regulations or administrative burdens.[44] The *Small Business Council of America* has questioned whether businesses will offer ERSA plans when business owners could save substantial amounts in RSAs and LSAs,[45] and the *Profit-Sharing/401(k) Council of America* is concerned that "many employees will redirect their retirement savings to LSAs and use their accumulations for non-retirement purposes."[46] The *American Savings Education Council* also is concerned that Lifetime Savings Accounts would divert money from retirement accounts and that people "would be very tempted to use [savings] for things other than long-term financial security."[47] Critics also suggest that the proposed changes to the rules that keep employer-sponsored plans from favoring highly-paid employees would leave employers with fewer reasons to assure that lower-paid workers participate in the plan. Employers would have less incentive to provide matching contributions or to encourage rank-and-file workers to contribute to the company's retirement plan.[48]

Some retirement specialists have expressed concern that eliminating tax-deductible contributions to traditional IRAs would harm low- and middle-income workers, who favor these accounts. Others have pointed out that people "could take home-equity loans . . . deduct their payments of mortgage interest and put the money in a 'retirement savings account' or a 'lifetime savings account,' where it could earn tax-free profits indefinitely. The costs to the Treasury . . . could be huge over the

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[42] *PRIVATE PENSIONS: Issues of Coverage and Increasing Contribution Limits for Defined Contribution Plans*, GAO-01-846, September 2001, page 3.

[43] Keifer, et al., *National Tax Journal*, vol 55 (No.1), March 2002, page 112.

[44] See the EBRI 2002 *Small Employer Retirement Survey* at [http://www.ebri.org/].

[45] "SBCA warns that Administration's retirement plan proposal will cause millions of small business employees to lose retirement plan contributions,"SBCA, February 5, 2003.

[46] "President's proposals will reduce the appeal of employer plans," PSCA, February 5, 2003.

[47] Donald Blandin, President of ASEC, as quoted in *Newsday* (New York), February 6, 2003.

[48] "Retirement savings proposal has small but significant changes," *Wall Street Journal*, February 4, 2003.

long run as investment income built up and remained tax-free forever."[49] It also has been suggested that §529 savings plans could temporarily offer a way to escape the $7,500 annual contribution limit on Lifetime Savings Accounts.[50] A family could open a §529 plan in a child's or grandchild's name and then convert it to an LSA. There would be no limit on the amount that could be converted from a §529 plan into an LSA, but the conversion would have to be made in 2003. Contributions to §529 plans made after 2003 could not be converted. Treasury officials admit that, "there's an issue with 529 plans."[51]

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[49] "Taking steps toward goal of no tax for investors," *The New York Times*, February 6, 2003.

[50] Section 529 plans are state-sponsored college savings plans. Contributions are not tax-deductible for federal income tax purposes, but earnings on the contributions grow tax-deferred.

[51] "Bush budget would shrink federal revenue," *The Washington Post*, February 4, 2003.