Navigating Income Planning for the Younger Client

Authored By: Heather L. Schreiber, RICP®

2020 has been anything but predictable for American workers and their families. Record numbers of unemployment claims and unanticipated early retirements have surged as businesses struggle to stay afloat. As a result, you may find yourself working with younger clients looking for options to tap into retirement savings in order to fill an income gap.

Generally, retirement accounts and IRAs may not be withdrawn prior to age 59 ½ without a 10% penalty applied to the taxable portion of the distribution. Like any rule, there are some exceptions that apply unilaterally to such accounts; death, disability, and payment of unreimbursed medical expenses that exceed certain thresholds are examples. Others, such as the payment of higher education expenses, withdrawals used for a first-time home purchase up to $10,000, or a qualified distribution to an alternate payee, may apply to IRAs or qualified retirement plans, but may not apply to both.

For a list of exceptions and the plans to which they apply, visit: irs.gov/retirement-plans/plan-participant-employee/retirement-topics-tax-on-early-distributions. Becoming familiar with the various exceptions to the 10% penalty, and the plans to which they apply, is important when discussing early income planning with your clients and prospects. While you should never engage in tax advice, your knowledge in this area could help a client better navigate their options.

You are likely familiar with some of the tried and true exceptions to the early withdrawal tax mentioned above. On the other hand, there are some exceptions that may either cause confusion or are recent (and provide temporary relief), such as the coronavirus-related distributions. These are the focus of this month's article.

Coronavirus-Related Distributions (CRDs)

These distributions were born out of the CARES Act, signed into law in March 2020. They also have a short shelf life; an eligible individual has until December 31, 2020, to request a CRD distribution. The maximum amount that may be treated as a CRD from all IRAs and retirement plans (excluding defined benefit plans, which are not eligible) is an aggregate $100,000.

A CRD is also not subject to the early withdrawal penalty that would generally apply to under age 59 ½ distributions. Absent other sources of liquid cash, this may be a viable option to consider for your younger clients.

You are an eligible individual if:

1. You, your spouse, or a dependent has tested positive for SARS-CoV-2, the virus that causes COVID-19;
2. You, your spouse, or a member of your household experiences adverse financial consequences as a result of being furloughed, laid off, or a reduction in work hours as a result of COVID-19;
3. You, your spouse, or a member of your household experiences adverse financial consequences due to an inability to work because of a lack of childcare;
4. You, your spouse, or a member of your household experiences adverse financial consequences due to a reduction in business hours or the closing of a business you own or operate due to COVID-19.

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The tax liability on an eligible CRD may be spread ratably over three years. Any unused portion of a CRD may also be rolled back within three years, beginning with the day after a CRD is distributed from an eligible retirement plan. Any such rollover of a CRD does not count against the one-rollover-per-12-month rule. For a detailed discussion of the most recent guidance on CRDs, refer to IRS Notice 2020-50: irs.gov/pub/irs-drop/n-20-50.pdf.

Here's an example:

Joe meets the requirements for a CRD and elects to take one from his IRA in the amount of $60,000. Joe will include $20,000 in each of the three tax years: 2020, 2021, and 2022. Conversely, Joe could elect to pay all the taxes in 2020. Joe may also elect to roll all or a portion of the proceeds back into the IRA within three years from the date of distribution to avoid taxation of the amount recontributed.

The Fine Print:

The application of CRDs created under the CARES Act applies to eligible retirement plans, including 401(k)s and IRAs; however, a qualified plan sponsor is not required to permit such a distribution. Your clients should check with their employer to determine if a CRD is permitted under the terms of the plan.

Future guidance on reporting such distributions is expected from the IRS. Individuals should strongly consider whether a CRD makes sense, long-term, particularly if the retirement account from which they exercise the distribution is already at a loss due to market conditions.

Commonly Asked Questions:

Q: Can I take a CRD from my 401(k) and roll it directly to my IRA?

A: Assuming the employer permits CRDs, IRS Notice 2020-50 Section 2B states that the plan sponsor is not required to offer a direct rollover option to the plan participant. However, the 20% mandatory withholding requirement that normally applies to eligible rollover distributions does not apply to CRDs. Therefore, upon receiving such distributions, and to the extent that the funds are not needed by the participant, the money may be rolled into an IRA or other eligible plan beginning the day after the CRD was distributed, but no later than three years from such date.

Q: If I am eligible for a CRD, may I convert the distribution to a Roth IRA and spread the tax liability ratably over three years?

A: No. Section 1D of IRS Notice 2020-50 states that only a CRD that is eligible for "tax-free rollover treatment" may be recontributed to another eligible retirement plan within three years from the date of distribution. Therefore, a Roth IRA does not meet the eligibility criteria for tax-free treatment and a CRD that is subsequently converted to a Roth IRA must be treated as income in the year it is converted.

Q: Do I have to prove that I needed the CRD and/or how I used the funds?

A: No. Section 1C states that an eligible individual who has experienced adverse financial consequences may still request a CRD without needing or proving that the amount of the distribution met the specific financial hardship caused by the coronavirus.

Q: My 401(k) only offers in-service withdrawals once I reach age 59 ½. I am only 49. Am I able to take a CRD from my 401(k) plan?

A: A plan sponsor is not required to offer a CRD under the terms of the plan. However, even though non-hardship, in-service withdrawals are generally not permitted until age 59 ½, plan permitting, CRDs are exempt from this age requirement. Therefore, it is possible that the plan

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may allow a CRD, regardless of the participant's age. The CRD would also be exempt from the 10% early withdrawal tax.

Series of Substantially Equal Periodic Payments – "72(t) Payments"

A series of payments that meets the definition of substantially equal periodic payments tend to be the first option considered when an ongoing income need arises, or is not limited to a one-time income deficit. I will refer to them as 72(t) payments. As a refresher, 72(t) payments are a series of equal payments made monthly, quarterly, or annually, longer than five years or until age 59 ½.

What gets lost in translation sometimes is the fact that the IRS outlines strict guidance on how these 72(t) payments must be calculated. Refer to Revenue Ruling 2002-62 (irs.gov/pub/irs-drop/rr-02-62.pdf) for a detailed explanation of the rules. It's worth the read to get a full appreciation of the fact that the IRS means business if your client chooses to use the strategy.

Here's what you need to know:

1. There are three IRS-approved methods to choose from when determining the amount of the series of 72(t) payments.
2. Failure to use one of the approved methods, or a miscalculation of the same, could result in a retroactive assessment of the 10% early withdrawal penalty plus interest from day one.
3. Once the frequency of payments is chosen, the same must be used for the duration of the payment schedule. For example, a monthly payment cannot later be switched to quarterly or annual payments.
4. No additions or distributions outside of the series of 72(t) payments may be made into or out of an IRA (or IRAs) used to calculate the series of payments during the duration of payments. If such action occurs, the retroactive penalty plus interest will apply.
5. Any of the series of payments may not be rolled back into an eligible retirement plan or IRA.

Practical Implications:

72(t) payments, calculated under one of the three IRS-approved methods, may not adequately satisfy the income gap the client is trying to replace. Therefore, the strategy, in many cases, isn't an exact fit and becomes a decision of whether to "do with less" or find another source of income. Randomly choosing an annual distribution figure and "sticking with it" for longer than five years or age 59 ½ will not work! I have seen this mistake made time and time again.

The calculated payment must comply with IRS guidance and is a derivative of the IRA balance, the IRA owner's age, and, in two of the methods, 120% of the Applicable Federal Midterm Rate in the month payments are to begin or in the two months prior. With current rates at historic lows, this means that a greater balance is needed to provide the same amount of income, were it not for the dip in interest rates. Historic 7520 interest rates may be found here: irs.gov/businesses/small-businesses-self-employed/section-7520-interest-rates.

If the payments are intended to offset an income deficit, individuals must understand that payments must continue without interruption for the duration to avoid potential penalties and interest. Your clients should speak to their tax advisors before electing this strategy to ensure they have a full appreciation of the benefits and trade-offs of using the strategy to avoid the 10% penalty.

The Overlooked Age 55 Rule

In my time working with financial professionals, this next exception is, bar none, the one that catches financial professionals by surprise the most. Many have never heard of it, yet it can be one of the

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most beneficial methods to solve a client's need for income, without adopting a 72(t) payment plan that may not meet the need in the first place.

Here is how it works. If a participant in a 401(k), 403(b), or TSP plan separates from service in the year he turns age 55 or later, a distribution from the plan directly to the participant is not subject to the early withdrawal penalty. Therefore, the sweet spot is for clients who leave employment somewhere between age 55 and before 59 ½, who otherwise would not meet an exception to the 10% penalty. Keep in mind that the exception does not apply once the funds are rolled to an IRA, so the distribution must be made directly to the participant to be eligible for the exception.

It is important to note that this exception is subject to two simultaneous requirements:

1. Separation from service, AND
2. Occurring in the year the employee attains age 55 or later.

Therefore, if an employee separates from service at age 53 and doesn't take a distribution from the plan until she is 55, the exception does not apply, since both requirements weren't met in the same year.

Certain public safety officials, like border protection officers, air traffic controllers, federal law enforcement, and firefighters can substitute age 50 for age 55 for this exception.

Also, notice that the employee simply needs to reach age 55 in the year of separation. This means that an employee who loses a job at age 54, but who turns 55 by year-end of the same year, would also be eligible.

Consider this hypothetical example:

Joseph recently lost his job along with many of his co-workers. Joe is 57-years-old and is understandably concerned about the loss of income. Another employee told him about the 72(t) payments exception, so he plans to discuss the option with his tax advisor.

If he elects to go that route, he will need to continue the series of payments for five years, even though he will be 59 ½ in two and a half years. Further, the series of payments may or may not meet Joe's income needs. Finally, he will also have to continue the series of payments, even if his income need is short-lived, causing him to tap into his retirement nest egg earlier and longer than he may need it. Joseph plans to immediately look for other work.

Is there another solution?

Possibly. Joseph might also consider taking a distribution directly from his 401(k) plan to bridge income from now until he reaches age 59 ½. He may elect to roll the rest of his 401(k) balance to an IRA for post-59 ½ income needs. By doing so, he will be able to get the immediate income he needs, without having to commit to a series of payments that may have to continue beyond the point at which he needs them.

These are clearly uncertain times that may require individuals to pivot to an earlier income solution. Familiarity with these early withdrawal strategies will help you have meaningful conversations with clients in need of income prior to age 59 ½. Always encourage your clients to seek counsel from their own tax advisors before engaging in a course of action. If you would like to discuss any of these strategies, reach out to your marketer. We are here to help!

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