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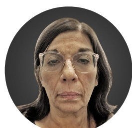
11 Ways To Tap Retirement Cash Early, Without A 10% Penalty



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Gallery: 11 Ways To Tap Retirement Cash Early

11 images

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Recently, a 50-year-old friend asked me where to put extra cash he wanted to save for retirement, but was worried he might have to use to pay college bills for his high-school age twins. This fellow had been feeding a 401(k) as well as 529 state college savings accounts for his kids. But he now had extra income from moonlighting and wondered whether he should use it to fund a

tax-deductible SEP-IRA (a special individual retirement account for the self-employed), or should pour his extra savings into the 529s.

Simple question? Not when Congress, in its wisdom, has seen fit to create more than a dozen different tax-advantaged retirement savings accounts, each with its own rules on contributions, loans, and when you can take money out without paying a 10% "early withdrawal" penalty on the distribution. Indeed, all those retirement accounts and rules are one of the reasons that National Taxpayer Advocate Nina E. Olson recently singled out tax code complexity as the biggest problem facing taxpayers. (For my advice to my friend---advice which is further complicated by the college financial aid formulas---see the end of this story.)

Of course money you put in a retirement account should ideally stay there until you retire. But life happens. Divorce, job loss, illness, and the real estate crash, to say nothing of the soaring cost of college, have forced many Americans to withdraw funds from retirement accounts early. Buried in an obscure IRS report is this disturbing fact: On their 2010 tax returns, Americans paid an estimated $5.8 billion in penalties on retirement account withdrawals. (That's *in addition* to the regular tax owed on those withdrawals.)

Still, if you need the cash early, there are a variety of ways (11 are detailed in the slideshow above) to avoid penalties. All that complexity can make you crazy, but it can also work for you---if you can know the rules. One common tactic is to borrow from your own 401(k). The law allows you to borrow up to $50,000 or half your vested balance, whichever is less, and to take up to five years to pay the money back (with interest) to your own account. Employers don't have to offer 401(k) loans, but most big firms do. There is, however, a potential trap: If you leave or lose your job, your ex-employer will likely demand quick repayment and if you can't repay, treat the outstanding balance as an early distribution, subject to penalties.

Another less well-known option: You can avoid the withdrawal penalty at any age, and for any reason, by beginning "substantially equal periodic payments" from an IRA. The catch here is you must continue taking these payments for five years or until you are 59 1/2 (the age you can normally start taking from an IRA penalty free), whichever comes later--even if you no longer need the cash. Incredibly, there are three possible ways to calculate the periodic payout. In the simplest, which produces the smallest annual payout, you divide the IRA's total value by your remaining life expectancy. Claudia Hill, president of Tax Mam, in Cupertino, Calif., and a Forbes contributor, recommends you work backwards. First, figure out how much cash you need and then calculate out how big an IRA will produce that annual distribution. Then, split your IRA, with one piece holding just the amount needed to produce your desired annual payout. Later, if you need still more cash before 59 1/2, you can draw it from the second account, without jeopardizing penalty-free distributions from the first.

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Watch out, too, for timing traps. Example: You can take a penalty-free distribution from either a 401(k) or an IRA to cover out-of-pocket medical expenses that exceed 10% of your adjusted gross income. But those expenses must be paid in the same year you take the distribution. (Note: Through 2012, the expenses only had to exceed 7.5% of your AGI. For 2013, that rose

to 10% of AGI---along with the threshold for deducting medical expenses---as part of the tax increases in Obamacare.)

So what was my advice to that 50-year-old? Complicating matters is the issue of whether his daughters will qualify for college financial aid. To maximize his eligibility for such aid, my friend should stuff his 401(k) and SEP-IRA before he puts more in his 529s, since colleges don’t consider what’s already in your retirement accounts when they’re calculating how much you can afford to pay for college, and how much aid you might need. By contrast, what’s in the 529s will raise the amount the colleges calculate he can pay. (For more explanation, see *Save For Retirement Now, Get More College Aid Later*.) Anyway, his pre-tax SEP-IRA contributions will reduce his current federal tax bill, whereas money put into a 529 doesn't yield a current federal tax deduction, although it may produce a state income tax break.

Later, if my friend does need to tap into his retirement stash to pay the bursar, he can borrow up to $50,000from his 401(k), paying it back over time, with interest, to himself. (Since he’s got great job security, this isn’t a risky move.) After that, if he needs still more college cash, he can take a withdrawal from his SEP-IRA to pay college tuition and fees---he’ll owe ordinary taxes, but no penalty, on that withdrawal. (Note the different rules for different accounts---he can’t take penalty-free college tuition withdrawals from his 401(k) and he can't borrow from an IRA.) Yet another twist: anything he withdraws from his SEP-IRA raises his adjusted gross income and could reduce his eligibility for college financial aid the year following the withdrawal. So all this has to be carefully timed, with money from a SEP-IRA withdrawn last, if needed, to pay for the twins’ senior year college tuition.

Maybe knowing this arcane stuff helps keep me employed. But my friend has more worthwhile things to do with his time and his grey matter than figure this all out---and I'll bet you do too. Are you listening Congress?

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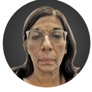

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I'm the Washington D.C. bureau chief and an assistant managing editor of Forbes. During my three decades with Forbes, I've reported extensively on taxes -- tax policy, tax planning, tax shelters and tax evasion. These days, I also edit personal finance and fintech coverage in Forbes and coordinate outside tax, retirement and personal finance contributors to Forbes.com. You can email me at jnovack@forbes.com and follow me on Twitter @janetnovack. **Read Less**

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