



Early Withdrawals and Required Minimum Distributions in Retirement Accounts: Issues for Congress

John J. Topoleski
Analyst in Income Security

January 4, 2012

Congressional Research Service

7-5700

www.crs.gov

R40192

Summary

In response to the economic downturn, Congress considered providing relief to Americans by suspending two tax penalties on defined contribution retirement plans and Individual Retirement Accounts (IRAs). First, Congress considered allowing individuals to make withdrawals from their retirement accounts without paying a 10% penalty for withdrawals from retirement accounts by individuals under the age of 59½. Second, Congress considered suspending a requirement that most individuals aged 70½ and older withdraw a certain percentage of their retirement account balance each year (known as a Required Minimum Distribution [RMD]). In December 2008, the House and Senate passed H.R. 7327, which suspends the RMD requirement for calendar year 2009. On December 23, 2008, President George W. Bush signed this bill into law (P.L. 110-458). For calendar year 2010, RMDs have resumed.

The reasons for these proposals are that (1) the increased economic insecurity among American households means that households might consider using retirement account funds for current emergency expenses; and (2) since many individuals have at least a portion of their retirement accounts invested in the stock market, the decline in the stock market means that many retirement account balances have seen significant declines. Because the required minimum distribution taken in any year is a percentage of the account balance at the end of the previous year, many RMDs taken in 2008 were a larger percentage of the account balance on the date of the withdrawal than on December 31, 2007.

This report discusses the reasons offered in support of suspending these provisions, as well as the drawbacks. This report also presents data that estimates the number of households that these proposals would impact. Borrowing from retirement plans as an alternative to withdrawals is also discussed. Finally, the report discusses the kinds of proposals offered to either suspend or eliminate the early withdrawal penalty or the required minimum distribution provision.

This report will be updated as legislative activity warrants.

Contents

Introduction.....	1
Early Withdrawal Penalty	2
Background.....	2
Tax Treatment of Early Withdrawals.....	3
Hardship Withdrawals	3
Borrowing as an Alternative to Hardship Withdrawals	4
Policy Issues	5
Required Minimum Distributions.....	6
Background.....	6
Estimates of the RMD	9
Policy Issues	10
Proposals to Eliminate or Suspend the 10% Early Withdrawal Penalty	11
Proposals to Eliminate, Suspend, or Delay Required Minimum Distribution Requirements.....	12

Figures

Figure 1. S&P 500: December 31, 1998, to December 27, 2011	7
--	---

Tables

Table 1. Ability to Borrow or Make Withdrawals Among Households that Have a Defined Contribution Plan.....	2
Table 2. Households that Had a Retirement Plan Loan in 2007	5
Table 3. Required Minimum Distributions in 2007	9
Table 4. Required Minimum Distributions by Households Where the Head is Aged 70 or Older	10

Appendixes

Appendix. Early Withdrawals Without Penalty: “Substantially Equal Periodic Payments”	13
--	----

Contacts

Author Contact Information.....	17
---------------------------------	----

Introduction

Congress has been considering providing relief to Americans who have become increasingly worried about their financial security. Among the options, some have proposed reducing or eliminating the penalties on certain transactions in tax-advantaged retirement accounts. The accounts include Individual Retirement Accounts (IRAs) and qualified defined contribution (DC) plans such as 401(k) plans, 403(b) plans, and 457(b) plans.

Two proposals have been suggested: (1) suspending the penalty tax for withdrawals from IRAs and DC plans that applies to individuals under the age of 59½; and (2) suspending the penalty tax for not taking Required Minimum Distributions (RMDs) from these plans, which would primarily affect individuals aged 70½ and older. Although the proposals may temporarily ease individuals' financial concerns, there are potential drawbacks to be considered.¹ Suspending the penalties might alter the participant's behavior away from the congressional intent that these plans provide for financial security in retirement and not be used for either pre-retirement expenses or as tax-free asset transfers to heirs. Suspending the penalty for early withdrawals would potentially leave individuals fewer assets in retirement from which to draw income. Suspending the penalty for failure to take required distributions would provide an incentive to use retirement accounts as permanent tax shelters or for intergenerational bequests.²

One of the proposals has been enacted into law. In December 2008, the House and Senate passed H.R. 7327, which suspends the RMD requirement for calendar year 2009. On December 23, 2008, President George W. Bush signed this bill into law (P.L. 110-458).

Workers benefit from tax-advantaged accounts because they are funded with pre-tax income. The U.S. Treasury estimates that the amount of the tax deduction in FY2012 to FY2016 received by 401(k) plan participants will be \$356.2 billion and by IRA holders will be \$80.5 billion.³ Because the accounts are funded with pre-tax income, the accounts then have a larger base from which to accumulate investment returns compared to non-tax advantaged accounts. An additional advantage is that the funds accumulate tax-free earnings. Income tax is paid on the contributions and accrued investment earnings when they are withdrawn. To ensure that the accounts provide income during retirement, individuals with these accounts face penalty taxes for using the accounts for most expenses prior to the age of 59½ or for failing to take required distributions after the age of 70½.

¹ For additional background see CRS Report RL31770, *Individual Retirement Accounts and 401(k) Plans: Early Withdrawals and Required Distributions*, by John J. Topoleski.

² Since less than 1% of estates pay the estate tax, the government would not receive much tax revenue from these plans if the RMD requirement were eliminated and households transferred the account balances their heirs. See CRS Report RS20609, *Economic Issues Surrounding the Estate and Gift Tax: A Brief Summary*, by Jane G. Gravelle.

³ Table 17-1, Analytical Perspectives, *Budget of the United States Government Fiscal Year 2012*.

Early Withdrawal Penalty

Background

As the worsening economy increases Americans' economic insecurity, individuals may view their retirement accounts as a source of funds to help meet current expenses. Current law discourages the use of funds for pre-retirement expenses by imposing a penalty for some early withdrawals.

A plan that allows access to retirement account funds to current employees prior to the age of 59½ must do so through either hardship withdrawals or loans. Employers are not required to allow employees access to their DC retirement accounts before the age of 59½ or prior to separation from employment, but may provide for the option of making withdrawals or borrowing from the plan. The conditions for making withdrawals or taking a loan must be included in the Summary Plan Description.⁴ **Table 1** indicates that 80.1% of households with a DC plan are able to make withdrawals and 69.8% of households with a DC plan can take loans.⁵ **Table 1** also indicates that most households in which the head of the household is younger than 60 years old have access to their retirement accounts either through the ability to make withdrawals or the ability to borrow. Only 15.1% of households can neither borrow nor make withdrawals.

Table 1. Ability to Borrow or Make Withdrawals Among Households that Have a Defined Contribution Plan

Number of Households	Can Make Withdrawals	Can Borrow	Can Make Withdrawals and Borrow	Can Neither Borrow Nor Make Withdrawals
34,789,000	27,857,000	24,278,000	22,580,000	5,235,000
100.0%	80.1%	69.8%	65.0%	15.1%

Source: CRS analysis of the 2007 Survey of Consumer Finances.

Note: Data in the table refers to households where the head of the household is younger than 60 years old.

⁴ A Summary Plan Description is a plan document required by law that describes how the plan operates. Among other items, SPDs contain information about eligibility and vesting requirements, plan benefits, and the source of contributions.

⁵ Data in this report comes from the 2007 Survey of Consumer Finances (SCF). The SCF is a triennial survey of household wealth, conducted on behalf of the Board of Governors of the Federal Reserve. The most recent survey was conducted in 2007.

Tax Treatment of Early Withdrawals

Funds that are withdrawn from either traditional IRAs or DC plans must be included in that year's gross income. To discourage the use of retirement savings for expenses incurred prior to retirement an additional 10% tax must be paid on the amount that is included in gross income, unless the amount is rolled over into another qualified plan or IRA.⁶ The 10% early withdrawal penalty does not apply to distributions if they are taken

- after the individual has reached the age of 59½ ;
- if the individual is a beneficiary of a deceased IRA owner;
- if the individual is disabled;
- in substantially equal payments over the account holder's life expectancy;⁷
- after separation from employment after the age of 55;
- for unreimbursed medical expenses in excess of 7.5% of adjusted gross income (from IRAs only);
- for medical insurance premiums in the case of unemployment;
- for higher education expenses (from IRAs only);⁸
- to build, buy, or rebuild a first home up to a \$10,000 withdrawal limit (from IRAs only);⁹ or
- if the individual is a reservist called to active duty after September 11, 2001.¹⁰

Hardship Withdrawals

In order for DC plans to offer hardship withdrawals, IRS regulations must be followed.¹¹ Specifically, distributions prior to the age of 59½ from a DC plan to an individual employed by the company sponsoring the plan must be on account of hardship, which is defined as an

⁶ See 26 U.S.C. § 72(t).

⁷ See the **Appendix** for a further explanation of the exception to the 10% penalty for substantially equal period payments.

⁸ 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.

⁹ 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 two 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.

¹⁰ Individuals who were affected by Hurricanes Katrina, Rita, or Wilma in 2005 or the Midwestern floods in 2008 were able to take penalty-free distributions of up to \$100,000 from their retirement plans. See 26 U.S.C. 1400Q.

¹¹ IRS regulations for hardship distributions from 401(k) plans are found in 26 C.F.R. § 1.401(k)-1(d)(3). Distributions from 457(b) can be made to meet an unforeseeable emergency. See 26 C.F.R. § 1.457-6(c).

immediate and heavy financial need of the employee. The following expenses are deemed to be on account of immediate and heavy financial need:

- certain medical expenses,
- costs related to the purchase of a principal residence,
- tuition and educational expenses,
- payments to prevent eviction or foreclosure on a mortgage,
- burial/funeral expenses, or
- expenses to repair a principal residence.

Individuals must pay income tax on the amount of the hardship withdrawal distribution and, unless the distribution is for one of the exceptions listed in 26 U.S.C. § 72(t), individuals taking hardship withdrawals must also pay the 10% penalty tax. Regulations require that an individual who takes a hardship withdrawal is not permitted to make contributions to the plan for six months following the withdrawal.¹² As a consequence, the account would not receive the employer match. Automatic employer contributions which are not part of a matching contribution could still be made.

Unlike funds in DC plans, funds in IRAs may be withdrawn for any reason, although the amount of the withdrawal must be included in gross income and is subject to the 10% early withdrawal penalty unless one of the exceptions in 26 U.S.C. § 72(t) applies.

Relatively few households make hardship withdrawals from their retirement plans, although early distributions from retirement accounts may be increasing as a result of the worsening economy. For example, the Vanguard Center for Retirement Research noted that fewer than 2 per 1,000 participants took a hardship withdrawal from their Vanguard 401(k) plan in 2010.¹³ It is uncertain to what extent individuals have been increasing early withdrawals from IRAs, which might be preferred to hardship withdrawals from DC plans because individuals do not have to prove hardship to make withdrawals from their IRAs.

To help households that are in financial distress, some suggest that Congress temporarily waive the early withdrawal penalty of 10% to allow easier access to retirement funds. Although the proposal would help households in financial difficulty, it would run counter to Congress' stated intention that these accounts be used to encourage retirement savings. In addition, the account balances would be irrevocably harmed because (1) the individual does not have to repay the withdrawn funds to the account, and (2) the individual would lose at least six months of contributions and any employer match.

Borrowing as an Alternative to Hardship Withdrawals

As indicated in **Table 1**, households often have the choice between making a hardship withdrawal or borrowing from the DC plan. Borrowing has several advantages:

¹² See 26 C.F.R. § 1.401(k)-1(d)(3)(iv)(E)(2).

¹³ Available at <https://institutional.vanguard.com/VGApp/iip/site/institutional/researchcommentary/article/InvResExamineLoans>.

- Compared with other kinds of loans, the application process is generally uncomplicated and involves little paperwork. In addition, credit checks and proof of financial hardship are not required;
- The loan usually has an interest rate of one or two percentage points above the prime lending rate. This is most likely cheaper than other sources of credit available to households;
- The interest payments are credited to the borrower’s account, rather than to the lending institution. This reduces the cost of the loan to the difference between the loan interest rate and the return on the plan’s assets; and
- Borrowers can continue contributing to their accounts while making the loan payment, which prevents a large break in contributions from occurring.

Table 2 indicates that 14.6% of households that could borrow from their retirement plan in 2007 had an outstanding loan. Among households with incomes of \$50,000 or less, 19.5% had an outstanding loan. Among households with incomes from \$50,001 to \$75,000, 20.1% had a loan. Households that make more than \$75,000 are more likely to have a loan outstanding than households that make less than \$75,000.

Table 2. Households that Had a Retirement Plan Loan in 2007

Income	Number of Households that Can Borrow from Their DC Plan (thousands)	Number of Households that Have an Outstanding Loan (thousands)	Percentage of Households that Can Borrow that Have an Outstanding Loan
Income less than or equal to \$50,000	4,737	924	19.5%
Income \$50,001 - \$75,000	5,455	1,097	20.1%
Income \$75,001 - \$100,000	4,487	588	13.1%
Income more than \$100,000	9,599	934	9.7%
All Households	24,278	3,543	14.6%

Source: CRS analysis of the 2007 Survey of Consumer Finances.

Notes: Data in the table refers to households where the head of the household is younger than 60 years old. Percentages indicate percentage within each income group (i.e. 5.2% of households that have an income under \$25,000 and that can borrow have an outstanding loan).

Policy Issues

Suspending the penalty for early withdrawals from retirement plans might help people in financial need. Some temporary relief might be justified, particularly with the economy in recession. Individuals might have difficulty making ends meet and might not have ready access to funds to pay for ordinary expenses. In addition, suspending the penalty might encourage participation among households that are eligible but who do not currently participate in a DC plan or have an IRA. Some individuals, particularly those with lower incomes, might decline to participate out of concern of limited or costly access to the funds in their retirement accounts if

they have emergency expenses. Plans that allow access to their funds may have higher participation or contribution rates than plans that do not.¹⁴

However, the drawbacks of allowing access to retirement savings prior to retirement need to be considered. First, funds that individuals take from their retirement accounts to pay for current expenditures will not be available when the individuals retire; this is a concern because most households rely on a combination of Social Security and withdrawals from their DC plans or IRAs as income sources in retirement. Second, suspending the penalty on withdrawals would not help individuals who are not permitted access to their retirement accounts. Finally, Congress has from time to time added to the exceptions to the early withdrawal penalty. Each exception increasingly makes the plans appear to be tax-deferred *savings* accounts, rather than the tax-deferred *retirement* accounts—the original intention for the tax code changes establishing these accounts.

Required Minimum Distributions

Background

Certain account holders are required to withdraw a percentage of their accounts each year, called a *Required Minimum Distribution* (RMD).¹⁵ The RMD assures 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. The RMD for a year is based on the account balance on December 31 of the prior year and on the life expectancy of the account holder or over the joint life expectancies of the account holder and his or her designated beneficiary.¹⁶ The distributions from these plans must begin no later than April 1 of the year after the owner reaches the age of 70½. Participants in employer-sponsored plans who are still working at the age of 70½ can delay distributions until April 1 of the year after they have retired. This exception does not apply to traditional IRAs. In traditional IRAs, the required beginning date for distributions is always April 1 of the year after the participant reaches the age of 70½. Failure to take the RMD results in a tax penalty equal to 50% of the amount that should have been distributed. In addition to individuals aged 70½ and older, an individual who inherits an IRA and who is not the spouse of the deceased account holder must take the RMD based on the inheriting individual's life expectancy.¹⁷

As noted above, the RMD is based on the account balance on December 31 of the year prior to taking the distribution. Financial advisors generally suggest holding assets in a retirement account in a well-diversified portfolio composed of stocks and bonds. They also suggest that the percentage invested in bonds increase with age. In practice, most households hold a large fraction of their retirement accounts in equities. Data from the 2007 Survey of Consumer Finances indicate that households invest about 68% of their IRAs in stocks; among households in which

¹⁴ See, for example, U.S. General Accounting Office report, GAO/HES-98-5, 401(k) Pension Plans: Loan Provisions Enhance Participation But May Affect Income Security for Some.

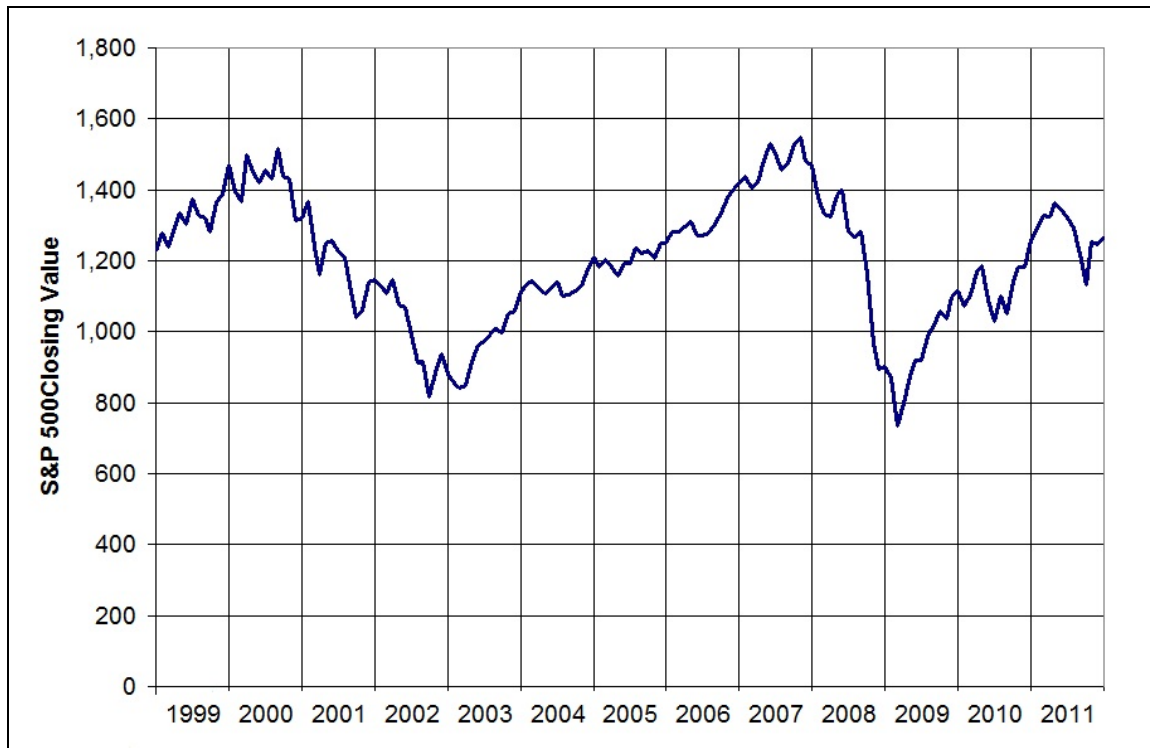
¹⁵ See 26 U.S.C. § 401(a)(9).

¹⁶ See IRS Publication 590, *Individual Retirement Arrangements (IRAs)*, for details on determining which table in appropriate for a particular taxpayer.

¹⁷ Roth IRAs have no RMD rules.

the head is aged 70 or older the percentage of their IRA assets invested in stocks is 67%. **Figure 1** shows the value of the S&P 500 market index from December 31, 1998, through December 27, 2011. In four of these 13 years, the S&P 500 stock market index finished the year lower than when the year began. In fact, since 1950 the S&P 500 index finished below its starting value in 16 of 60 (26.7%) years. For example, at the end of 2008, the S&P 500 index was 39.4% lower than its value on December 31, 2007. This precipitous stock market drop was one of the reasons for the calls to suspend the RMD requirement. For many account holders the account balances of their retirement plans were likely to be lower at any point in 2008 compared with December 31, 2007. Thus, the percentage of the account that has to be withdrawn is likely to be higher than it would be if the RMD were based on the value of the account when the RMD is distributed.¹⁸

Figure 1. S&P 500: December 31, 1998, to December 27, 2011



Source: CRS.

For households whose retirement account balances have lost value because of the decline in the stock market, suspending the tax for failure to take the RMD would allow these households to recoup the losses as the stock market rises faster than if they were required to withdraw the funds. Although the funds from the RMD do not have to be spent, taxes would have to be paid. The funds could then be invested in similar financial assets in a non-tax advantaged account. However, because income taxes must be paid on the funds that are withdrawn from the tax-advantaged

¹⁸ For example, suppose an individual's account balance was \$100,000 on December 31, 2007, and declined to \$60,000 on the date that the RMD is taken. If the individual is required to withdraw 10% of the account, then the RMD is \$10,000. However, because of the decline in the account balance, the individual has to withdraw $\$10,000/\$60,000 = 16.7\%$ of their account.

account, the non-tax advantaged account would have a smaller base from which to accrue investment returns. In addition, the investment returns would not accrue tax-free.

Suspending the RMD penalty tax would benefit households that might prefer to not make withdrawals from their retirement accounts to preserve their wealth for possible future expenses, such as long-term care. In addition, wealthier households that have adequate income from sources other than retirement accounts would benefit because these funds would continue to grow in accounts where the investment earnings are tax-deferred. Lower-income households that are drawing down their retirement accounts to pay ordinary expenses would likely not benefit from the removal of the tax for failure to take the RMD, as they would likely be withdrawing funds from their retirement accounts regardless of RMD penalty tax. Finally, households that had most of their retirement account invested in safe assets, Treasury bonds for example, would likely not have seen sharp declines in their account balances. Nonetheless, these households would also benefit from a suspension of the RMD requirement.

Suspending the RMD requirement can be accomplished by Congressional action to alter the tax code; it could also be accomplished through Department of Treasury regulations. Section 401(a)(9)(A) of the Internal Revenue Code requires that entire account balances be distributed either (1) not later than the required beginning date, or (2) beginning not later than the required beginning date over the life of the individual (or the individual and a designated beneficiary) in accordance with regulation.¹⁹ The life expectancy tables are published in the IRS regulations. The regulations note that the tables “may be changed by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin.”²⁰ On October 10, 2008, House Education and Labor Committee Chairman George Miller and Health, Employment, Labor, and Pensions Subcommittee Chairman Robert Andrews called on Secretary of the Treasury Henry Paulson to suspend the tax penalty for seniors that do not take the RMD.²¹ The letter stated:

We believe that you have the legal authority to effectively eliminate this penalty by not requiring the RMD for 2008. Current law requires minimum distributions over the life of the retiree. However, the Treasury regulations interpret this as requiring annual distributions. By taking action, seniors will avoid taking unnecessary losses in their retirement accounts and avoid the current excise tax. We request that you take this action immediately to help protect and rebuild the retirement savings of older Americans.

W. Thomas Reeder, benefits tax counsel, Department of Treasury, said that Treasury is looking at ways to change the RMD rules administratively.²² On December 9, 2008, William Bortz, associate benefits tax counsel for Treasury’s Office of Tax Policy,²³ said the department is likely to release information about minimum required distributions soon.²³

¹⁹ 26 U.S.C. § 401(a)(9)(C) defines the required beginning date as the later of (1) April 1 of the year after reaching age 70½ or (2) the calendar year in which the employee retires. For IRAs, the required beginning date is April 1 of the year in which the account holder reaches the age of 70½. See 26 C.F.R. §§ 1.401(a)(9)-0 through 1.401(a)(9)-9.

²⁰ See the answer to question 4 in 26 C.F.R. § 1.401(a)(9)-9.

²¹ The letter is available at http://www.house.gov/apps/list/speech/edlabor_dem/10102008PensionRule.html.

²² Treasury Is Weighing Options for Waiving Minimum Withdrawal Penalty During Crisis, *Pension & Benefits Daily*, Bureau of National Affairs, Inc., October 22, 2008, available at http://news.bna.com/pdln/PDLNWB/split_display.adp?fedfid=10953879&vname=pbdnotallissues&fcn=3&wsn=499910500&fn=10953879&split=0.

²³ Treasury Official Talks of Solution to Ease Losses from Minimum Required Distributions, *Pension & Benefits Daily*, Bureau of National Affairs, Inc., December 10, 2008, available at http://news.bna.com/pdln/PDLNWB/split_display.adp?fedfid=11134188&vname=pbdnotallissues&fn=11134188&jd=A0B7P5G7U1&split=0.

On December 10, 2008, the House passed H.R. 7327, the Worker, Retiree, and Employer Recovery Act of 2008, which would suspend the RMD requirement for calendar year 2009. On December 11, 2008, the Senate passed H.R. 7327. On December 23, 2008, President George W. Bush signed this bill into law (P.L. 110-458).²⁴ In a letter dated December 17, 2008, to Chairman Miller, the Department of Treasury indicated that the Treasury Department and the Internal Revenue Service would not take further action on RMD requirements for calendar year 2008 because of administrative constraints faced by individuals and plan sponsors.

The RMD waiver for 2009 expired on December 31, 2009. Individuals can receive their RMDs at any time during the year. While legislative proposals are introduced to waive the RMD requirement for one or more years, providing RMD relief after the beginning of a year could present administrative difficulties for plan administrators and the Treasury.

Estimates of the RMD

Table 3 contains data from the 2007 Survey of Consumer Finances (SCF), which indicate that in 2007 more than 5 million households had a head of household who was aged 70 or older with balances in a retirement account that would likely be subject to the RMD. The 5.16 million households subject to the RMD had total account balances of \$855.7 billion.²⁵ The average account balance was \$165,707 and the median account balance was \$50,000. Using the table for single life expectancy on page 89 from IRS publication 590, CRS estimates that \$67.2 billion would have been withdrawn in RMDs from these accounts. The average RMD would have been \$13,026 and the median RMD would have been \$4,000.²⁶ The large difference between the mean and median RMD estimates suggests that while some households have large RMDs, most households have more modest minimum distributions.

Table 3. Required Minimum Distributions in 2007

Age	Number of Households (thousands)	Total Account Balances (millions)	Average Account Balance	Median Account Balance	Total Required Minimum Distribution (millions)	Average RMD	Median RMD
70 - 74	2,054	\$533,712	\$259,822	\$71,000	\$34,272	\$16,684	\$4,459
75 - 79	1,347	\$150,626	\$111,822	\$50,000	\$12,503	\$9,282	\$4,256
80 +	1,763	\$171,400	\$97,220	\$29,000	\$20,496	\$11,626	\$3,431
Total	5,164	\$855,738	\$165,707	\$50,000	\$67,271	\$13,026	\$4,000

Source: CRS analysis of the Survey of Consumer Finances (SCF).

Notes: Dollar amounts adjusted for inflation to December 2007 using the Consumer Price Index.

²⁴ After the enactment of P.L. 110-458, the IRS provided guidance to financial institutions on reporting RMDs in IRS Notice 2009-9.

²⁵ The dollar amounts in this paragraph are adjusted for inflation to reflect the value of the accounts at the end of 2007.

²⁶ These numbers compare closely with those found in the Survey of Income Program and Participation, which indicates that 5.5 million households were headed by persons aged 70 or older with an IRA or 401(k) Account in 2005. See CRS Report RL31770, *Individual Retirement Accounts and 401(k) Plans: Early Withdrawals and Required Distributions*, by John J. Topoleski.

Table 4 classifies the RMD data by four household income groups where the head of the household is aged 70 or older: less than \$25,000; from \$25,001 to \$50,000; from \$50,001 to \$75,000; and more than \$75,000. Although only 29.2% of households make more than \$75,000, these households receive 73.6% of the RMD. The 54.7% of households that earn \$50,000 or less, take 17.9% of the RMD. This income group would likely be taking the RMD for living expenses anyway. Most of the benefit of removing the RMD penalty would likely go to the higher-income households. The amount of income tax that these households would pay ultimately depends on many factors.

Table 4. Required Minimum Distributions by Households Where the Head is Aged 70 or Older

	Income less than or equal to \$25,000	Income \$25,001-\$50,000	Income \$50,001-\$75,000	Income more than \$75,000
Number of Households (thousands)	954	1,870	832	1,509
Percentage of Households	18.5%	36.2%	16.1%	29.2%
Total Account Balances (millions)	\$30,494	\$103,286	\$92,111	\$629,849
Percentage of Total Account Balances	3.6%	12.1%	10.8%	73.6%
Average Account Balance	\$31,978	\$55,241	\$110,755	\$417,340
Median Account Balance	\$16,000	\$36,500	95,000	\$100,000
Total RMD (millions)	\$2,511	\$9,504	\$8,259	\$46,997
Percentage of Total RMD	3.7%	14.1%	12.3%	69.9%
Average RMD	\$2,633	\$5,083	\$9,931	\$31,141
Median RMD	\$1,358	\$3,059	\$7,853	\$10,135

Source: CRS analysis of the 2007 Survey of Consumer Finances.

Notes: Percentages may not add up to 100% due to rounding.

Policy Issues

Suspending the penalty for failure to take the RMD gives individuals—mostly those older than 70½—the opportunity to recover the losses in their retirement accounts more quickly than if the funds were withdrawn and placed in a non-taxed advantaged account that held similar or identical investments. However, given the amount of the typical (median) RMD amount of approximately \$4,000, the benefit to most households would likely be modest. In addition, lower-income households are not likely to benefit from the suspension of the RMD penalty. Lower-income households would likely be making withdrawals from their retirement accounts even if the penalty on the failure to take the RMD were to be suspended.

One option would be to allow households to make the RMD based on their account balance at the time of the withdrawal, thus ensuring households that their RMD is not “too large” relative to the account balance at the end of the previous year. However, this could prove costly for plan administrators to implement. In addition, if permanent, this option would not lead to the full distribution of the account over the expected lifetime of the account holder, as required by current law.

Another option would be to raise the age at which required distributions would begin. Assuming the requirement to fully disburse the account over the expected lifetime of the individual remains in place, implementing this policy option would merely raise the amount of required distributions, since the account would still need to be fully dispersed. This would occur over a fewer number of years.

Some have suggested eliminating the RMD requirement altogether. This would be identical to providing tax-free conversions from traditional IRAs to Roth IRAs. There would likely be a large cost to the U.S. Treasury. In 2006, the U.S. Treasury reported \$124 billion in taxable IRA distributions from IRAs.²⁷ In addition, individuals who had previously converted from a traditional to a Roth IRA might consider eliminating the RMD requirement unfair because they had previously paid taxes on their conversions.²⁸

Proposals to Eliminate or Suspend the 10% Early Withdrawal Penalty

Some policy analysts have suggested various proposals to eliminate or suspend the 10% early withdrawal penalty in certain circumstances. In general, the proposals would add a paragraph to 26 U.S.C. § 72(t) to eliminate the penalty in a particular circumstance. Note that with each provision added to 26 U.S.C. § 72(t) the accounts increasingly operate more like general tax-deferred *savings* accounts and less like tax-deferred *retirement* accounts.

The proposals include eliminating or suspending the 10% early withdrawal penalty for

- public safety employees who retire before the age of 55,²⁹
- workers who are unemployed,³⁰
- individuals affected by natural disasters,³¹
- homeowners at risk of having their mortgage foreclosed,³²
- individuals who receive a hardship distribution from a retirement plan,³³
- victims of ponzi schemes;³⁴ and
- individuals who have qualified adoption expenses.³⁵

²⁷ See Statistics of Income Tax Stats, Table 1: Individual Income Tax, All Returns: Sources of Income and Adjustments, available at http://www.irs.gov/taxstats/indtaxstats/article/0,,id=133414,00.html#_complete.

²⁸ For more information see IRS Publication 590, *Individual Retirement Arrangements (IRAs)*.

²⁹ See, for example, S. 1432 in the 112th Congress and H.R. 721 in the 111th Congress.

³⁰ See, for example, S. 1650, H.R. 659, H.R. 2756, H.R. 2806, and H.R. 3234 in the 112th Congress and H.R. 656 and H.R. 1311 in the 111th Congress.

³¹ See, for example, H.R. 1424/P.L. 110-343 in the 110th Congress.

³² See, for example, H.R. 1656 and H.R. 3104 in the 112th Congress, and H.R. 1629 and H.R. 2331 in the 111th Congress and H.R. 5822, H.R. 5776, H.R. 4627, and S. 2201 in the 110th Congress.

³³ See, for example, H.R. 7278 in the 110th Congress.

³⁴ See, for example, H.R. 1635 in the 112th Congress.

³⁵ See, for example, H.R. 1576 in the 112th Congress and H.R. 2524 in the 111th Congress.

Proposals to Eliminate, Suspend, or Delay Required Minimum Distribution Requirements

Policymakers have suggested various proposals to eliminate or suspend the RMD requirements. These proposals would

- suspend the RMD requirement through 2012;³⁶
- eliminate the RMD requirement;³⁷ or
- raise the required beginning date, which would raise the age at which individuals must begin taking their RMDs.³⁸

³⁶ See, for example, H.R. 2516 in the 112th Congress and H.R. 3903 or H.R. 2021 in the 111th Congress.

³⁷ See, for example, S. 820 in the 112th Congress and H.R. 396 and S. 1040 in the 110th Congress.

³⁸ See, for example, H.R. 2756 in the 112th Congress and H.R. 882, H.R. 2331, and H.R. 2637 in the 111th Congress.

Appendix. 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 the age of 59½ are “part of a series of substantially equal periodic payments,” they are not subject to the 10% penalty that otherwise would apply.³⁹ 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* five years after the first distribution or the date on which the plan participant reaches the age of 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.⁴⁰ 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
- 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 may 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 the account owner’s 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 the distribution 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

³⁹ 26 U.S.C. §72(t)(2)(A)(iv).

⁴⁰ I.R.S. Notice 89-25 (March 20, 1989) and Revenue Ruling 2002-62 (October 3, 2002).

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.”⁴¹

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 expectancy 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) five years after the first distribution or (2) the date on which the plan participant reaches the age of 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 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 value⁴² 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 IRS and an interest rate that does not exceed 120% of the federal mid-term rate.⁴³ Under this method, the account balance, the annuity factor,

⁴¹ Twila Slesnick and John C. Suttle, *IRAs, 401(k)s, and Other Retirement Plans: Taking Your Money Out*, Fourth Edition, (2002), page 4/4.

⁴² 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.

⁴³ The current federal mid-term rate can be found on the IRS website at <http://www.irs.gov/taxpros/lists/0,,id=> (continued...)

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 began taking substantially equal periodic payments in October 2008. 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.⁴⁴ Assume an account balance of \$100,000 on September 30, 2008, 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 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 \$5,824.⁴⁵ 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 two 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 also would be \$5,824.⁴⁶ 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

(...continued)

98042,00.html.

⁴⁴ IRS Publication 590, Appendix C, Table 1. 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.

⁴⁵ Amount is based on an interest rate of 4.0% and a remaining life expectancy of 29.6 years.

⁴⁶ This is based on an annuity factor of 17.1687.

See <http://www.studyfinance.com/common/table4.pdf> for the annuity factors used.

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. In October 2002, the IRS 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. The smaller distributions that result from this switch will prevent retirement accounts from being depleted as rapidly as would occur under either of the other two methods.

Revenue Ruling 2002-62 also states that

- If an account owner takes periodic payments (SEPPs) and his or her account is exhausted before the age of 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 charges that otherwise would be levied.
- An interest rate of up to 120% of the federal mid-term rate for either of the two 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.

Author Contact Information

John J. Topoleski
Analyst in Income Security
jtopoleski@crs.loc.gov, 7-2290