RhodyMoney

Accessing Your 401k Before Age 59 ½

Jeffrey H. Massey
Certified Financial Planner™
Massey and Associates, Inc.

What to know before taking money from your retirement account prior to age 59 ½.

In this time of great uncertainty for many workers, we have received calls about withdrawing money from IRA accounts or retirement plans while under the age of 59 ½.

Let's start with the "tried and true" advice of having an emergency fund that should equate to at least 3 to 6 months of your living expenses. Establishing an emergency fund of this type should be a top priority for anyone that is still working or relying on that income to pay the bills.

Once you have retired, your source(s) of income is not depending on you actively working so, the emergency account may well be a smaller dollar amount. Everyone's situation can be different so, I recommend that you speak with a financial adviser to help you sort through the various issues pertaining to establishing your emergency account.

There are rules pertaining to withdrawing funds from 401k plans or IRA accounts, and of course, they are different.

If you leave your employment, whether you are downsized out of a job, fired or quit, it does not matter to the IRS. If you leave that job during, or after the year in which you become age 55 and prior to age 59 1/2, there is a special provision that allows you to withdraw funds from your 401k plan without the 10% early withdrawal penalty. Many people are unaware of this special provision.

Keep in mind that is the IRS rule. However, your 401k plan may not allow you to take such withdrawals, so, it is important to start by inquiring with a plan representative as to the availability of this type of withdrawal.

A recent client wanted to withdraw under this IRS provision, however, his plan would only allow a one-time withdrawal from the 401k plan. He wanted to withdraw the equivalent of four years of income, which would have put him into a much higher tax bracket. Obviously, not a good idea.

So, what is a person to do that is faced with such a dilemma?

The easy answer is to transfer the 401k into an IRA that you can control. The important thing to remember is that you cannot just take a withdrawal from an IRA prior to age 59 ½. But, there is another tax rule that allows you to create an income stream from your IRA account.

The IRS code, section 72(t), allows an individual to create an income stream, "no less than annually" from an IRA account and avoid the 10% early withdrawal penalty. The allowable payment is based on your life expectancy. Of course, there are rules that must be followed.

(Please remember that converting an employer plan account to a Roth IRA is a taxable event. Increased taxable income from the Roth IRA conversion may have several consequences including (but not limited to) a need for additional tax withholding or estimated tax payments, the loss of certain tax deductions and credits, and higher taxes on Social Security benefits and higher Medicare premiums. Be sure to consult with a qualified tax advisor before making any decisions regarding your IRA.)

Unlike the 401k rule that allows a penalty free withdrawal after the age of 55, the IRA 72(t) rules does not have an age requirement. The two rules that must be adhered to are, firstly, the payments must be made for a period of 5 years. Secondly, the final payment must be received after the individual becomes age 59 ½.

Let's look at two versions of a 72(t) payout that can avoid the early withdrawal penalty.

Let's say John starts taking his income payment at age 52. His payments must continue until he becomes 59 ½, so, that would require 7 ½ years of payments to qualify under the 72(t) rules.

Let's say that Celeste starts her payments when she is 57. In this case, the payments must continue for 5 years, even though she will be 59 ½ in just 2 ½ years.

Here is a note of caution. If you interrupt this type of a 72(t) payment stream in ANY way, or withdraw any additional money from the IRA account, the IRS will retroactively go back in time and charge you the 10% early withdrawal penalty plus interest from the date of each payment up to the time you violated the rules. Obviously, that is not in your best interest.

There are special software programs that we use to determine the best payout amounts based on the three methods of calculating these payments: the required minimum distribution (RMD), the annuitization and the amortization method. This is not something you should try on your own!

Another key point is to use the absolute minimum that you need to set aside for this type of payment stream and put that money into a separate IRA account. This will allow you to have other money available if you need it without interrupting the 72(t) payment stream and having to pay the penalty and interest charges.

I know this is technical, so, if you have questions, we are here to help!

For more information, contact the team at Massey And Associates, Inc., Retirement Wealth Advisors, at (401) 333-8000 and www.masseyandassociates.com. The office is located at 250F Centerville Road in Warwick.

Investment advisory services made available through AE Wealth Management, LLC (AEWM). AEWM and Massey And Associates, Inc. are not affiliated companies. Neither the firm nor its agents or representatives may give tax or legal advice. Individuals should consult with a qualified professional for guidance before making any purchasing decisions. 1409165 – 7/22