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NEWS RELEASE

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Tapping an IRA or 401(k) without Taking a Heavy Tax Hit

Thomson Reuters Tax Analyst Explains how to Take Advantage of Exceptions to the 10% Additional Tax on Pre-age-59½ Withdrawals.

New York, N.Y., May 26 2009 – With jobs and home loans hard to find, many individuals are making ends meet by tapping into their IRAs and 401(k) accounts long before reaching retirement age. Besides leaving less money for the retirement years, those withdrawals can produce a hefty tax bill. In general, distributions made before age 59½ are subject to regular income tax rates plus a 10% additional tax. “Fortunately, the tax law contains exceptions to the 10% additional tax, but the exceptions can be complicated and the rules can differ between IRAs and 401(k)s,” warns Bob D. Scharin, Senior Tax Analyst for the Tax & Accounting business of Thomson Reuters. “With a bit of planning, however, you may be able to wipe out owing the additional tax.”

For instance, suppose your money is still in a former employer’s 401(k) plan and you want to use an exception that applies to only IRAs. If you make a withdrawal from the 401(k), you will be out of luck. Instead, Scharin explains that you should take the simple step of rolling the funds over to an IRA and then getting the distribution from that account.

Here’s a look at some exceptions to the extra tax and how you can avoid common pitfalls to take best advantage of the exceptions:

1. Distributions from an IRA or former employer’s 401(k) plan that are part of a series of “substantially equal periodic payments” made for your expected life (or the joint lives of you and a beneficiary). “Basically, this lets you start making withdrawals at any age, provided the payments are figured as though you were turning your account into a lifetime annuity,” says Scharin.

Planning tip: Once you begin making withdrawals in this form, you cannot change the payment formula until the later of (a) your reaching age 59½ or (b) five years. Otherwise, you will be hit with the 10% additional tax retroactively.



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2. Distributions from an IRA or 401(k) plan to the extent your medical expenses exceed 7.5% of your adjusted gross income.

Planning tip: You need not itemize your deductions and claim a medical expense deduction for the year, but you must receive the distribution in the same year as the medical care. If you make the withdrawal in 2009 for the cost of surgery you expect to have in 2010, you will not qualify. Similarly, a distribution taken to pay off loans outstanding from prior-year medical costs does not qualify.

3. Distributions from an IRA by a qualifying unemployed individual to the extent of health insurance premium payments made for the individual and his or her spouse and dependents. To qualify, you must generally have received unemployment compensation for at least 12 consecutive weeks.

Planning tip: You must make the withdrawal during the year you received the unemployment compensation or the following year, but you cannot make the withdrawal more than 60 days after starting a new job.

4. Distribution from an IRA by first-time homebuyers. This exception to the additional tax is subject to a \$10,000 lifetime limitation.

Planning tip: The distribution must be used for the home purchase by the 120th day after the money is received.

5. Early IRA withdrawals to pay qualified college expenses. The expenses can be for you, your spouse, your children, or your grandchildren.

Planning tip: The withdrawal must be made in the same year as the expenses are incurred.

6. Distributions made after separation from service after attainment of age 55. This exception applies to 401(k) plans, but not to IRAs.

Planning tip: You must be at least age 55 when you leave the job. If you left the job at age 54, you cannot qualify simply by waiting until age 55 to begin the withdrawals.

Take two: If you qualify for multiple exceptions, you can use them in tandem, Scharin points out. For instance, you may have taken IRA distributions to pay for your child's college tuition and the family's health insurance premiums. The Tax Court recently held that you can even combine the exception for substantially equal periodic payments with the exception for higher-education expenses to get an unequal amount during years when college expenses are incurred.

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