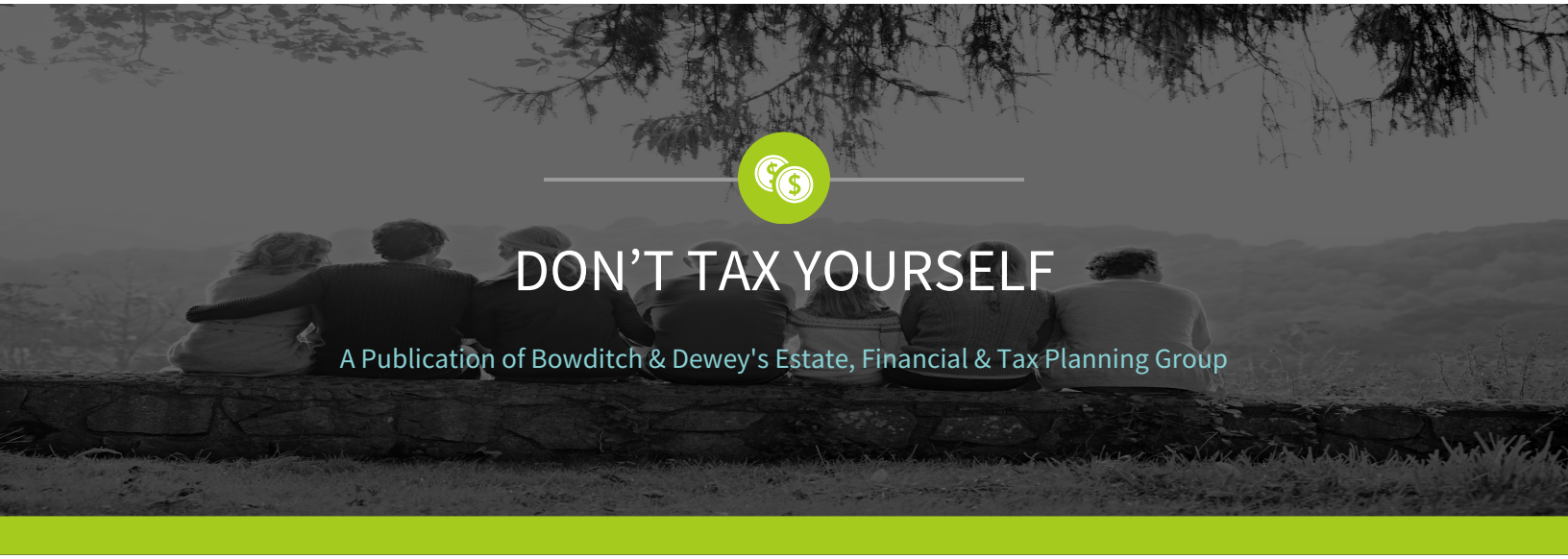

DON'T TAX YOURSELF

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Can I Withdraw Funds From My Retirement Account During COVID-19?

BY BOWDITCH & DEWEY • SEPTEMBER 25, 2020

The Paycheck Protection Program money is spent, the temporary $600 weekly unemployment supplement is over, and we still need money. We could draw on our savings, sell investments, or take out a loan against our home. Usually, we wouldn't even consider withdrawing from our retirement account while working. However, during this pandemic, the IRS has relaxed the rules so that for the first time ever, many of us are considering withdrawing from our retirement accounts.

Under the CARES Act, which passed on March 27, 2020, and the recently issued IRS Notice 2020-50, "qualified individuals" who withdraw funds from an eligible retirement account due to COVID-19 will receive special tax treatment.

The special tax treatment is generous, but do you qualify for it? Let's take a look:

STEP 1: ARE YOU A QUALIFIED INDIVIDUAL PURSUANT TO THE CARES ACT?

- You were diagnosed with COVID-19;
- Your spouse or dependent was diagnosed with COVID-19;
- You, your spouse, or a member of your household (someone who shares your principle residence) experienced adverse financial consequences as a result of:
  - Being quarantined, furloughed or laid off, or having work hours reduced due to COVID-19;
  - Having a reduction in pay (or self-employment income) due to COVID-19 or having a job offer rescinded or start date for a job delayed due to COVID-19;
  - Being unable to work because childcare is unavailable due to COVID-19; or
  - Closing or reducing hours of a business you own or operate due to COVID-19.

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If you are not a qualified individual, then you will not qualify for the special tax treatment and instead, you will be subject to the normal tax rules regarding loans or distributions from retirement accounts.

STEP 2: DID YOUR RETIREMENT PLAN ADOPT THE CARES ACT PROVISIONS TO ALLOW FOR APPLICATION OF THE SPECIAL TAX TREATMENT?

Ask your retirement plan administrator if they adopted all or some of the provisions of the CARES Act. Only the provisions of the CARES Act that they adopt will provide you with the special tax treatment. Otherwise, you will be subject to the normal tax rules.

I QUALIFY UNDER STEPS 1 AND 2. WHAT TYPES OF SPECIAL TAX TREATMENT ARE AVAILABLE TO ME?

- **Increased Withdrawal Amount:** If you are a qualified individual who makes a COVID-19 related withdrawal, you may withdraw up to $100,000 from your retirement plan in 2020.
- **Loan Amount:** The increased special loan limits of $100,000 expired on September 22, 2020, which means that the general rule of a $50,000 loan limit now applies, with an aggregate loan amount limited to 50% of the employee's vested accrued benefit.
- **Elect to Include Income Ratably Over 3 Years:** If you make a COVID-19 related withdrawal between January 1, 2020 and December 31, 2020, then when you file your income tax returns you may include the full amount for the year withdrawn or you may elect to include the income ratably over 3 years. The amount withdrawn will be taxed at the ordinary income tax rates, which means that depending upon the amount withdrawn, you may increase your ordinary income tax bracket in a tax year. This is why you may wish to elect to include the income ratably over 3 years on your income tax returns, rather than taking all of the income in one tax year. You should consult with a knowledgeable tax accountant or tax lawyer.
- **Waiver of the 10% Penalty for a Withdrawal Before You are 59½ Years Old:** You will ***not*** be subject to the usual IRS Code Section 72(f) additional 10% tax on the withdrawal amount for withdrawing the funds before you attain the age of 59 ½ years.
- **3 Years to Recontribute the Withdrawal Amount to Your Retirement Account:** Even if you do not intend or are too late to treat a withdrawal as a loan, within 3 years of the withdrawal, you may recontribute the funds into your retirement account. This is generous. Prior to the CARES Act, you had only 60 days to deposit the funds withdrawn from one of your retirement accounts into another one of your retirement accounts to avoid being taxed on the withdrawal. Note: if you redeposit the funds in the second or third year after the withdrawal year, then you will need to file amended income tax returns to report the recontribution and reduce your gross income by the deposited amount.
- **Suspension of Loan Repayments During 2020 by Your Employer:** If you withdrew the funds as a loan after March 27, 2020 and before September 22, 2020, or you already had a loan in place, then under the normal rules you must repay the loan to the retirement plan within five years. However, under the CARES Act, a qualified employer may suspend loan repayments between March 27, 2020 and December 31, 2020. If your employer suspends payments, you will not be required to make payments on the loan during the suspension period. In addition, the term of the loan may be extended by up to one year from the date the loan was originally due to be repaid. Note: interest accrues during the suspension period and the loan repayments must resume after the end of the suspension period.

IF I DON'T QUALIFY UNDER STEPS 1 AND 2, IS THERE SPECIAL TAX TREATMENT AVAILABLE TO ME?

Yes. Waiver of the 50% Penalty Tax for Late Withdrawal of RMDs: During the 2020 year, no one is required to take their required minimum distributions. Usually, if you must take your required minimum distributions from your retirement account in a given year, you must include the amount of withdrawn funds on your income tax return in the year it was withdrawn. If you had failed to withdraw the required minimum distribution amount, then the amount that

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is not withdrawn would be taxed at 50%. For the clients that do not need the cash, we recommend suspending their required minimum distributions during the 2020 year.

JUST BECAUSE I CAN, DOES IT MEAN THAT I SHOULD?

Although the special tax treatment of withdrawals is generous, consider taking only what you need because the bottom line may not be what you expect. Take careful consideration of where the investment market is at the time of your withdrawal. As an example, let's assume that you are in the 20% ordinary income tax bracket. In January 2020, your retirement account value was $142,857, and then the market drops by 30% in the Autumn of 2020, leaving your account at $100,000. You, your spouse, or someone in your home has experienced adverse financial consequences due to COVID-19. You decide to get out of the market while it is down and withdraw the funds. Thanks to the special tax relief, you do not pay the 10% penalty on the $100,000 withdrawal. However, you are in the 20% tax bracket for ordinary income taxes, which means you pay $20,000 to the IRS in the following year, or you may elect to pay it ratably over 3 years. Bottom line: you pocket $80,000 when you had an investment value of $142,857, essentially losing $62,857 of investment retirement assets because you sold when the market was low and paid the required taxes.

Instead, if you are financially able and you qualify for the special tax treatment, you should consider withdrawing the funds, then converting the $100,000 to a Roth IRA. A Roth IRA is a retirement account where you pay the income tax upfront, then you invest the funds for your lifetime, without any mandatory distribution rules. In the example above, you would pay the 20% tax on the conversion of $100,000 and since you haven't cashed out, you are still invested in the same market, so you can participate in the uptick in the market at a later date. During your lifetime, you won't be required to withdraw required minimum distributions on the Roth IRA, allowing you to let the investment grow as long as you desire. Note: since the IRS is not requiring the usual 20% withholding tax on a retirement withdraw under the CARES Act, you can leverage this further by using your own funds to pay the taxes, allowing you to convert the entire withdrawal amount to the Roth IRA.

* There are many nuisances and exceptions to the rules. We recommend that you contact your retirement plan provider and your accountant or tax attorney to discuss in depth how these rules apply to you.

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