



Expand Opportunities for Homeownership and Education: Align 401(k) and IRA Pre-retirement Uses

The vast majority of individual's savings is done through employer-sponsored retirement plans. Even funds in IRAs are funds rolled over from employer's retirement plans. Legislators seeking to promote long-term savings and investment have focused on strategies to increase access to employer accounts.

As housing and college costs increase and credit markets become tighter, families will need greater cash for down payments and tuition. Some assert that the most likely place for individuals to accumulate such funds is in a retirement account. While many assert that these funds should be used solely for retirement, it could be argued that accessing retirement account funds for pre-retirement asset purchases can make families more financially self-reliant in retirement: Homeowners and college graduates have higher levels of savings than those without those assets.

Access to funds in retirement accounts is governed by federal rules defining specific contribution and withdrawal stipulations for both retirement and pre-retirement uses. While many of the distribution rules are designed to discourage early withdrawals, using accrued assets for intermediate investments in appreciating assets – such as homeownership, small business and education - can yield long-term benefits and enable greater ability and opportunity to save, build wealth, prepare for retirement, and create a more secure financial future.

IRC Section 72(t)(2)(E) and (F) permit IRA account-holders to make penalty free withdrawals for homeownership and higher education. However, current 401(k), 403(b), and other employer-sponsored plans do not provide such clear guidance. Individual firms' practices can vary substantially. Aligning pre-retirement 401(k) distribution rules with IRA rules defined in IRC Section 72(t)(2)(E) and (F) would encourage more aggressive participant savings as employees would be able to save for an intermediate and a long term goal simultaneously in a proven, accessible savings product.

Variances in the Rules on IRA and 401(k) Withdrawals for Homeownership and Education:

The IRA rules are relatively straight forward. The law allows funds to be withdrawn from an IRA if being used to pay for the accountholder's higher education expenses or the higher education expenses of a spouse, child or grandchild if those funds are used in the year the money is withdrawn. For homeownership, up to \$10,000 may be taken out of an IRA for the purchase of a first home for the accountholder or the accountholder's spouse, child or grandchild. None of these funds need be repaid.

Employers also have considerable discretion in determining what constitutes a hardship withdrawal. Obtaining a hardship withdrawal is a difficult and lengthy process, usually determined by severe financial need, necessary to prevent foreclosure or bankruptcy, and only available if all other avenues for securing needed funds have been exhausted. Ironically, hardship withdrawals are also subject to both income tax and a 10% early withdrawal penalty; the 10% penalty is also included in the full taxable amount. Typically, the accountholder may not contribute to the 401(k) for six months following the hardship distribution.

The employer-based accounts rules are different. While funds may be withdrawn tax-free and penalty-free from a 401(k) loan, plan participants are required to repay the loans, plus interest, with after-tax dollars. Though interest rates vary from plan to plan, a typical rate is the prime rate plus 1%. General-purpose loans must be repaid within five years; loans for homeownership must be repaid over the course of fifteen years in substantially level payments. In most cases, an employee leaving a firm must repay the entire balance

immediately. Employers are not required to permit loans from 401(k) plans. If an individual removes money from an account, they cannot contribute to that account for a set period of time. If an account holder is unable to meet the repayment criteria, they will be charged a ten percent penalty and owe taxes that decrease the accountholder's savings and limit his or her ability to make large-scale, appreciating investments.

Research has shown that the biggest reduction in balance is not hardship withdrawals but people cashing out when they leave a job. The percent of Americans taking loans from an employer account remains modest – it rose from 11% in 2006 to 18% in 2007; 6% of these were for education expenses while 13% and 15% reported the loan was used for first-time homeownership in 2006 and 2007 respectively. With an increasing number of Americans taking 401(k) loans, rules should simplify pre-retirement withdrawals used for appreciating asset purchases.

Campaign Promise:

President Obama's statement in Toledo, Ohio on October 13, 2009: "We also need to give families and retirees more flexibility and security when it comes to their retirement savings...I propose that we allow every family to withdraw up to 15% from their IRA or 401(k) – up to a maximum of \$10,000 – without any fine or penalty throughout 2009."

Recommended Action:

Permanently align 401(k) and 403(b) rules with IRA penalty free withdrawals for homeownership and education. Allowing penalty-free early withdrawals for specified investments would encourage people to save more in their retirement plans, knowing they would be able to access the money for intermediate, asset purchases. Override the Jones vs. IRS 2005 Tax Court case.

Raise the IRA homeownership withdrawal limit to from \$10,000 to \$20,000 in order to more accurately reflect current down-payment requirements.

Legislative Language:

IRC Section 72(t)(2)(E) and (F) permit penalty free withdrawals from individual retirement accounts for higher education and first-time homeownership; these rules should be expanded to include penalty free withdrawals from 401(k), 403(b), etc. plans.

Resource Information:

<http://my.barackobama.com/page/community/post/amandascott/gGgb5H/commentary>

<http://www.barackobama.com/pdf/issues/economy/EconomicPolicyFullPlan.pdf>

[http://www.taxalmanac.org/index.php/Sec. 72. Annuities%3B certain proceeds of endowment and life insurance contracts](http://www.taxalmanac.org/index.php/Sec.72.Annuities%3B%20certain%20proceeds%20of%20endowment%20and%20life%20insurance%20contracts)

http://www.washingtonpost.com/wp-dyn/content/article/2006/01/21/AR2006012100195_pf.html

For more information:

Carol Wayman, Federal Policy Director, CFED, 1200 G Street, NW, Suite 400, Washington, DC 20005
(202) 207-0125 work, (202) 725-0762 cell, Cwayman@cfed.org