# IRA UPDATE: FEBRUARY 2012

**IRS Announcement 2011-81**

On December 12, 2011, IRS announced temporary relief for some taxpayers who engaged in a prohibited transaction of extending credit between personal assets and IRA assets through a cross-collateralization agreement. These agreements are essentially considered a loan between and IRA owner and his/her IRA which is not allowed.

If an IRA owner engages in a prohibited transaction, the result can be loss of the tax-deferred status of the IRA which means the account affected is considered to have been distributed in that year and thus is taxable and possibly subject to the 10% early distribution penalty if the IRA owner is under 59 ½. One of these prohibited transactions is using your IRA as collateral for a loan or extending credit to or from the IRA to a disqualified person.

In this particular case, the issue is the guarantee of a debt of an IRA with non-IRA assets which is the same as loaning money to your IRA and thus a prohibited transaction and should be avoided. As with any transaction that could possibly result in a prohibited transaction, it is advisable to separate the amount of money being used for the transaction to a separate IRA so that if a prohibited transaction occurs, only the separated account is affected, not the entire IRA. Still best to avoid potential prohibited transactions and if you are concerned about a prohibited transaction, seek guidance from a knowledgeable IRA advisor.

**10% Early Distribution Penalty Exceptions for Health Insurance Premiums of Unemployed Persons**

An IRA owner must be 59 ½ when taking distributions from their retirement account(s) otherwise they will be subject to the 10% early distribution penalty unless one of the exception applies. One of the lesser known exceptions to the 10% early distribution penalty is for unemployed persons paying health insurance premiums. In a recent court case, the IRS took a taxpayer to court over the 10% early withdrawal penalty for certain distributions. Expenses that were used for education and medical expenses were exempt from the 10% penalty. In addition the court cited that expenses used to pay for health insurance premiums due to unemployment were also exempted from the 10% penalty.

In order to qualify, the unemployed IRA owner can use IRA funds to pay health insurance premiums for himself, his spouse, and any dependents. This exception applies to IRA (including SEP and SIMPLE IRAs) only; it does not apply to plans such as 401k and 403b plans. It is not enough to simply be unemployed; additional requirements state that the person must have received unemployment compensation under any Federal or State system for at least 12 consecutive weeks as a result of losing their job.

Since this exception does not apply to plans such as 401k, a simple workaround would be to rollover (via trustee-to-trustee transfer) to an IRA and then take the distribution which would presumably qualify. If the person terminated service from their employer at age 55 or later, the age 55 exception to the 10% penalty would apply to distribution from

the 401k plan therefore the IRA rollover would not be necessary. There are a few other nuances in this exception, so if this applies to you or someone you know, it is critical to determine eligibility before taking the distribution from and IRA.

If you become unemployed, be careful if you plan to take a distribution from your company plan if you are younger than 59 ½ as the 10% may apply. However as indicated above, there is the age 55 penalty exception that states if you terminate service from your employer at age 55 or later, you can take a penalty free distribution from the plan. Of course you still pay income tax on the amount distributed.

Under this exception, the key point is that employment ends at age 55 or later, not when the distribution was taken. In the recent court case of Gail Marie Watson V. [IRS] Commissioner, the taxpayer took at distribution after the age of 55 however she separated service at age 53 and therefore was found to be liable for the 10% penalty.

A few points to consider here is that the taxpayer does not have to actually be 55 when they separate from service; rather the requirement is that the taxpayer attain the age of 55 in the same year that separation from service occurs. Also it is critical to understand that this exception is lost if the plan balance is rolled over to an IRA because once in an IRA, the 59 ½ rule applies. So if you think you might need access some of your retirement the money and you separate from service in the year you turn 55 or later, you might be better off waiting until you reach 59 ½ to rollover to an IRA or at least leave enough in the plan that you can access free of the 10% penalty.

You must actually be age 59 ½ or older when you take a distribution to avoid the 10% penalty unlike the age 55 exception that only requires you to attain the age of 55 in the year the distribution occurs.

The rules for IRA distributions can be complicated. If this applies to you, be sure to seek an advisor qualified in IRA distribution rules.

Sincerely,

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