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Congress waives surtax on large IRA withdrawals

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If you feel you need to withdraw more than $160,000 a year from your IRA to live on, Congress did you a big favor last year. A select few Americans, those who take out more than $160,000 annually, will pay fewer taxes over the next four years than they would have before this big favor.

Since 1987, taxpayers who withdraw more than annual allowable limits, $160,000 for 1997, would pay a 15 percent excise tax on the dollars over the limit in addition to regular income tax on those dollars.

When the excise taxes were enacted, Congress was concerned by the large IRA balances building up. The government was seeing IRA balances of $3 million to $5 million, and Uncle Sam's mouth started watering.

"The beneficial tax laws allowing tax deferred savings weren't meant for people to save that much," said Marty Rosenthal, partner at Schottenstein Zox & Dunn.

With balances that large, many times a taxpayer's minimum annual withdrawal was well over $100,000. The excise taxes were designed to take from those who withdrew more than Uncle Sam deemed necessary. In some cases, a taxpayer's minimum withdrawal exceeded the level at which the excise taxes would be applied.

"It was taking an extra piece from people who were pulling too much money out of their plans," Rosenthal said.

Then along came the Small Business Job Protection Act of 1996, signed into law by President Clinton last August. It suspends the excise tax on withdrawals made between Jan. 1, 1997 and Dec. 31, 2001.

No doubt, this change affects very few, very rich people. Critics complain of capital gains tax breaks that benefit only the rich, but this new provision benefits fewer, but much richer, people than any capital gains tax cut would help.

"For the megawealthy, there may be three to four cute tricks you could use to take advantage of this, but I have to tell you, it seems remote. Less than 1 percent of us would ever use this," said Jim Moneysmith, president of Alles Financial.

The average IRA balance at the time of retirement is $300,000 to $500,000, said Moneysmith.

People who will benefit from the change don't really need it, he said. In Moneysmith's opinion, if you need more than $160,000 a year to live on and you can withdraw it from your IRA, you can afford a little excise tax.

"If you can't live on less than $160,000, you're taking better trips than the rest of us are," Moneysmith said.

In addition, both Moneysmith and Rosenthal say the change probably is of limited value even to people rich enough to qualify. Of Alles' approximately 2,000 clients, none of them have ever been subjected to the excise tax, Moneysmith said.

Rosenthal could recall only one of his clients who pulled out extra cash from his IRA because of a tax problem. Otherwise, he has never had a client's IRA disbursements be subject to the 15 percent excise tax.

Most people who would have millions of dollars in an IRA account have already paid off their $200,000 mortgages and have a generous health plan to fall back on in case of catastrophic illness, Moneysmith said.

Even if a taxpayer had a large balance on a home mortgage and wanted to use the extra IRA money to pay it off, it might not make financial sense.

Rosenthal emphasized that just because you can do something doesn't mean you should. He said if you were withdrawing the money anyway at some point, now would be a good time to do it. But it should be done after some serious deliberation.

A taxpayer is constrained when it comes to withdrawing IRA funds and reinvesting them elsewhere. For instance, you can't use IRA funds to invest in collectibles, such as coins or art, or life insurance.

While neither expert seemed to be a big fan of the change, Moneysmith disdained the idea of giving a tax break to the "megawealthy" instead of cutting the capital gains. "A capital gains tax cut would help so many more people and so many more average-income folks," said Moneysmith.

In the meantime, those with $5 million in their IRA can take a real nice vacation this year.

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