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Avoiding Unfavorable Results of the Favorable Tax Treatment of Cares Act Withdrawals: An Unexpected Problem

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AVOIDING UNFAVORABLE RESULTS OF THE FAVORABLE TAX TREATMENT OF CARES ACT WITHDRAWALS:

AN UNEXPECTED PROBLEM

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In 2020, the year COVID-19 first attacked the United States, the Presidential administration made several attempts to lessen the financial burden on the people – offering stimulus payments, a series of student loan interest and payment pauses, and allowing individuals to make penalty-free early withdrawals from their retirement accounts, to name a few. While all these items seemed to offer relief, the way taxpayers applied their retirement withdrawals on their tax returns could actually cost them in terms of other COVID-19-related financial benefits as well as on their future tax returns, future tax savings, and other future AGI-based financial benefits. This article focuses on the CARES Act penalty-free early withdrawal from retirement accounts and some options taxpayers and preparers may want to consider for their clients.

The penalty-free retirement account early withdrawal opportunity came with another potential benefit, assuming it was from a traditional, pre-tax retirement account. Instead of claiming the entire amount of the retirement withdrawal in 2020, individuals were given the option to claim one-third of this retirement withdrawal in each of the next three years – 2020, 2021, and 2022. If an individual withdrew a large amount from their retirement, this option seemed advantageous as one could avoid having to pay tax on the entire amount of the retirement withdrawal at a higher rate, in a higher tax bracket, all in one year.

While at first glance this "favorable" tax treatment could be tax-beneficial, many individuals and families found that claiming one-third of their 2020 retirement withdrawal in each of the next three years actually caused financial harm. In some instances, claiming the additional income over three years caused not only the individual, but also their entire family, to become ineligible for the economic impact payment (stimulus payment) issued by the federal government in March 2021. How? Since eligibility was AGI-based, adding one-third of the 2020 retirement withdrawal to 2021 earned income sometimes resulted in the 2021 AGI exceeding the stimulus eligibility income limitation.

In those unprecedented times, nobody knew to expect one, let alone three economic impact payments (two in 2020 and one in 2021). They also did not know that individual and family eligibility for the stimulus payments would be based on income thresholds. Many individuals and families who would have otherwise been under the income thresholds and therefore eligible for the stimulus payments found that their AGI now exceeded the income limitation, resulting in a reduction or loss of stimulus payments and other financial benefits. They did not realize when they chose the option to report their 2020 retirement withdrawal as income over three years that they were inadvertently choosing to miss out on future benefits.

REAL-WORLD SCENARIO

Consider a couple filing MFJ with two young children (ages 3 and 7) that earns $140,000 in each of 2019, 2020, 2021, and 2022, and that the couple withdrew a total of $90,000 via a CARES Act distribution during 2020. (See Figure 1, Calculations of tax in 2020, 2021, and 2022 with $90,000 401(k) distribution spread across 3 years).

Figure 1: Calculations of tax in 2020, 2021 and 2022 with $90,000 401(k) distribution spread across three years

Taxpayer status	MFJ		
Number of children	2		
Ages of children	3 and 7	4 and 8	5 and 9
401(k) distribution	$ 90,000		
Additional income reported per year	$ 30,000	$ 30,000	$ 30,000
Income before distribution per year	$ 140,000	$ 140,000	$ 140,000
	2020	**2021**	**2022**
Income	$ 170,000	$ 170,000	$ 170,000
Standard deduction	24,800	25,100	25,400
Taxable income	145,200	144,900	144,600
Tax before credits	23,524	23,375	23,309
Economic Recovery Rebates*	(5,800)	-	-
Child Tax Credit	(4,000)	(4,600)	(4,600)
Tax	$ 13,724	$ 18,775	$ 18,709
Total tax before credits	$ 70,208		
Total tax paid	$ 51,208		

**2020 economic impact payments were based on 2019 income, which would have been below threshold.*

Assume 2019 income was equal to 2020 regular income of $140,000.

2021 economic impact payment was based on 2020 income but could be recouped based on 2021 tax return.

Since both 2020 and 2021 AGI were above the threshold, they did not receive the 2021 economic impact payment.

If the couple chooses the "favorable" tax treatment and opts to claim the retirement withdrawal over three years, their annual AGI will be $170,000 for 2020, 2021, and 2022. Both stimulus payments issued in 2020 were based on taxpayers' 2019 AGI and began phasing out at $150,000 AGI for married couples filing jointly. As this couple's 2019 AGI was $140,000, they received the full $3,400 for the first payment ($1,200 per adult plus $500 per child) and the full $2,400 for the second payment ($600 per adult plus $600 per child). The third stimulus payment, issued in March 2021, was also based on taxpayers' 2019 AGI if they had not yet filed their 2020 income tax returns, or on their 2020 AGI if they had. For this example, we assume that the couple did file their 2020 income tax return before the time the third stimulus payment was issued and the amount of their third stimulus payment was based on their 2020 AGI. Since the couple's 2020 AGI exceeded the stricter phase-out threshold that began at $150,000 and ended at $160,000, the third stimulus payment was eliminated entirely for this family; instead of receiving $5,600 ($1,400 per adult plus $1,400 per child), they received $0. As a result, the family received just $5,800 from the three economic impact payments.

Choosing the "favorable" tax treatment also caused a negative impact on the couple's child tax credits. By selecting the "favorable" tax treatment of their retirement withdrawal, their child tax credits were not impacted in 2020 but were reduced in 2021 and 2022; instead of receiving $6,600 in 2021 and 2022, their child tax credits were $4,000, $4,600, and $4,600 in each year, respectively. Instead of receiving child tax credits of $17,200, they received just $13,200. After considering the economic impact payments and child tax credits, this couple pays a total of $51,208 in taxes over the course of these three years.

Now consider the same couple, but assume they opted out of the "favorable" tax treatment and claimed all $90,000 of their retirement withdrawal in 2020. Their 2020 AGI would have been $230,000, while 2021 and 2022 AGIs would have each been $140,000. (See Figure 2, Calculations of tax in 2020, 2021, and 2022 with $90,000 401(k) distribution claimed all in 2020).

Figure 2: Calculations of tax in 2020, 2021 and 2022 with $90,000 401(k) distribution claimed all in 2020

Taxpayer status	MFJ		
Number of children	2		
Ages of children	3 and 7	4 and 8	5 and 9
401(k) distribution	$ 90,000		
Additional income reported per year	$ 90,000		
Income before distribution per year	$ 140,000	$ 140,000	$ 140,000
	2020	**2021**	**2022**
Income	$ 230,000	$ 140,000	$ 140,000
Standard deduction	24,800	25,100	25,400
Taxable income	205,200	114,900	144,600
Tax before credits	37,407	16,775	16,709
Economic Recovery Rebates*	(5,800)	(5,600)	-
Child Tax Credit	(4,000)	(6,600)	(6,600)
Tax	$ 27,607	$ 4,575	$ 10,109
Total tax before credits	$ 70,891		
Total tax paid	$ 42,291		

**2020 Economic impact payments were based on 2019 income, which would have been below threshold.*

Assume 2019 income was equal to 2020 regular income of $140,000.

2021 Economic impact payment was based on 2020 income but could be recouped based on 2021 tax return.

Since 2021 AGI is below the threshold, they received the 2021 economic impact payment.

In this alternative, the family would have still received $5,800 for the first two stimulus payments, and they would have initially missed out on the entire $5,600 at the time the third stimulus payment was issued (their 2020 AGI exceeded the entire phase-out threshold). However, this couple would recoup all $5,600 through the economic recovery rebate on their 2021 income tax return, in which their AGI fell below the phase-out threshold. By opting out of the "favorable" tax treatment in 2020, the family would recoup a total of $5,600 in economic impact payments.

In addition to the difference in stimulus payments given the two tax treatments, had the couple opted out of the "favorable" tax treatment, their child tax credits would be $4,000, $6,600, and $6,600 in each year, respectively, allowing them $4,000 more in child tax credits over three years. After considering the economic impact payments and child tax credits, this couple would pay a total of $42,291 in taxes over the course of these three years. Considering only the economic impact payments and the child tax credits, if the family chose the "favorable" tax treatment, they lost out on $9,600. This is tempered, however, by a $683 reduction of income tax resulting from choosing the "favorable" tax treatment. Netting the losses of the economic impact payments and child tax credits against the meager reduction of income tax, this family has missed out on a grand total of $8,917 in financial benefits by claiming the "favorable" treatment of their retirement withdrawal.

MORE POTENTIAL LOSSES

The stimulus payments and child tax credits were not the only casualty of benefits to some who chose to spread out their retirement withdrawal income. What other current benefits may have been negatively affected by claiming 2020 retirement withdrawal income over three years? Additional income-based benefits include student aid for higher education, education credits and deductions, Schedule E losses, retirement credits and contribution limits, and family-based credits, including the earned income tax credit, child tax credit, child and dependent care credit, and the adoption credit.

What other unprecedented benefits may be forthcoming for which those who chose the "favorable" tax treatment may be ineligible? Nobody knows for sure at this point what other new and innovative benefits may be presented to try to stimulate the economy, reduce inflation, or help families meet their needs. If the past is an indication, though, we should consider that more benefits and options are likely.

The student loan payment and interest pause remains in effect and has been extended several times by two different Presidential administrations. At present, these benefits are available to all federal student loan borrowers, regardless of income. However, if extended again, would any future pause be offered only to those under a certain income threshold? What about other student loan relief? In August 2022, President Biden announced federal student loan forgiveness of up to $10,000 (or up to $20,000 for those who received Pell Grants) per borrower earning less than $125,000, or $250,000 for MFJ or HoH, as determined by recent income (2021 income tax returns or income-driven repayment income certification). If recent history is a guide, eligibility for any future benefits will also depend on income.

IS THERE A SOLUTION?

There are a couple options available to avoid the scenario in which the loss of benefits outweighs the gain of spreading the tax burden over three years. First, the taxpayer can pay back the 2020 retirement withdrawal within three years of the date they received their withdrawal and amend their 2020, 2021, and 2022 (if applicable) tax returns to remove the retirement withdrawal income completely. This eliminates the income taxes on their 2020 retirement withdrawal and increases the likelihood of eligibility to recoup any missed or reduced stimulus payments, child tax credits, and other tax benefits based on income thresholds. However, depending on the amount borrowed and the taxpayer's current financial situation, many taxpayers may not be able to take advantage of this option.

A second option is to modify the previous choice by claiming the entire amount of the retirement withdrawal in 2020 and amending the 2020, 2021, and 2022 (if applicable) tax returns. Although this will increase the tax liability and late payment penalty on the 2020 tax return, it could greatly reduce 2021 and 2022 income taxes. In some scenarios, amending the 2020 and 2021 tax returns in this way may result in the taxpayer now becoming eligible for the full 2021 stimulus payment (which can be claimed as an Economic Recovery Rebate on their tax return), increased child tax credits, and other income-based benefits.

Going back to the example family above, amending their 2020 and 2021 tax returns to claim 100% of their retirement withdrawal in 2020 will result in their being able to keep their two 2020 stimulus payments (any overpayments were not added to the tax burden if a taxpayer had received "too much" based on their 2019 vs 2020, or 2020 vs 2021 returns), recoup their lost third stimulus payment from 2021, and recoup their reduced child tax credits. Amending their 2020 and 2021 tax returns also increases the likelihood for this example family to be eligible to take advantage of any potential upcoming student loan relief and other benefits which may also be income-dependent.

CONCLUSION

Now that we know all the benefits made available later in 2020 and throughout 2021, if a taxpayer is claiming their 2020 retirement withdrawal over three years, it is worth considering their potential gains from amending their 2020 and 2021 tax returns. In addition, any such taxpayer should also consider their eligibility for any upcoming AGI-based benefits, both expected and unexpected.

As President Biden has recently announced his plan for student loan forgiveness, now is a great time for borrowers to consider how their AGI may affect their eligibility for this significant potential benefit. If a student loan borrower claims one-third of their 2020 retirement withdrawal on their 2021 and 2022 tax returns, will they be ineligible for student loan forgiveness? Will borrowers be eligible for any potential interest and payment pauses extending past the end of 2022? While the Department of Education works out the implementation of student loan forgiveness, it may be smart to take steps now so that eligibility is not at risk when forgiveness is executed. While it has been possible to recoup losses of economic impact payments and child tax credits by amending prior tax returns, there is no guarantee that any similar option will be offered when it comes to student loan forgiveness.

Even if the net benefit resulting from opting out of the "favorable" tax treatment of 2020 CARES Act retirement withdrawal income and amending the 2020 and 2021 tax returns is small, taxpayers and preparers should still consider making this amendment for themselves and/or their clients. With student loan relief expected to be announced imminently, it is imperative that action be taken quickly to increase the taxpayers' likelihood of being eligible for this and any other future benefits.

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