



Distributions from IRAs and retirement plans; exceptions to the 10% penalty on early withdrawals

If any taxpayer takes an “early withdrawal” from a “qualified retirement plan”, the taxpayer will pay income tax on the amount taken **AND** a 10% penalty.

Couple of definitions needed – one, what’s a “qualified retirement plan”, and two, what are the exceptions to this general rule?

A “qualified retirement plan” is:

1. Any typical employer pension or profit sharing plan
2. Any IRA account
3. Any tax-sheltered or retirement annuity
4. Any plan that ever was treated as one of the prior three plans, even if it isn’t now.

“Early withdrawals” are withdrawals made **before age 59-1/2**; however, there are several exceptions:

1. Distributions made to a beneficiary (or to the estate of the employee) on or after the **death** of the employee.
2. Distributions attributable to the employee being **disabled**.
 - a. Is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or be of long-continued and indefinite duration, and
 - b. Furnishes proof of the disability in the form or manner required by IRS.
 - c. Qualifying for private disability doesn’t automatically mean you are exempt from the 10% penalty.
 - d. This area has been the subject of many court cases.
3. Distributions which are part of a series of substantially **equal periodic payments**, made:
 - (a) not less frequently than annually, (b) for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and his designated beneficiary.
4. Distributions made to an employee after **separation from service** after attainment of age 55. **This rule doesn't apply to distributions from IRAs.**
5. Distributions which are dividends paid with respect to stock of a corporation which is in an **ESOP**. But this exception from the 10% tax does *not* apply to dividends that are reinvested in qualifying employer securities pursuant to a participant's election.
6. Withdrawals from a qualified plan or IRA made on account of an **IRS levy** under Code Section 6331.

7. Distributions made to the employee (other than those described in (1) through (7), above, and in (8) and (9), below), to the extent they don't exceed the amount allowable as a **medical expense deduction** to the employee for amounts *paid during the tax year* for medical care (regardless of whether the employee itemizes deductions for the tax year). So, suppose a taxpayer has income of \$30,000 during the year. The allowable medical deduction will be the amount of medical expense that exceeds 7.5% of \$30,000 or \$2,250. So, suppose the taxpayer's medical costs that *are actually paid* during the year are \$7,250; the deduction allowed is \$5,000; \$7,250 paid - \$2,250 (7.5% of income). In this example, \$5,000 of a distribution from an IRA or pension plan would not be subject to penalty. Key point – you must have actually paid the medical costs during the year.
8. Any distribution made to an alternate payee under a **qualified domestic relations order** that relates to child support, alimony or marital property rights.
9. IRA distributions to certain unemployed individuals for **health insurance premiums**.
 - a. Distribution must be to the unemployed person.
 - b. They've received unemployment for at least 12 consecutive weeks.
 - c. The exception does not apply to any distribution received after being reemployed at 60 days.
 - d. The amount that is not subject to the penalty is limited to the amount of the health insurance premiums.
 - e. Self-employed persons qualify as well – IF they would have qualified for unemployment but for the fact they're self-employed (who determines that is left unsaid!)
10. Early withdrawal of IRA funds by “**first-time homebuyers**”
 - a. A “first-time” buyer is not really what it seems. It means anyone that has had no ownership interest in a residence during the two-year period preceding the “acquisition date”.
 - b. If it's a married couple filing the tax return both persons have to meet rule #1.
 - c. The “acquisition date” is either the date a binding contract to buy is signed or construction begins.
 - d. It appears that if both husband and wife qualify for this exception then they can both avoid the 10% penalty on the first \$10,000 withdraw from their respective IRA.
11. Early withdrawal of IRA funds to pay higher **education expenses**.
 - a. Does not apply to withdrawals from any other plan – only IRAs.
 - b. Expenses = tuition, books, supplies, required equipment (computer does not count if it's not required).
 - c. Graduate level expenses qualify.
 - d. Expenses can be incurred by the IRA owner, their spouse, child or grandchild.
 - e. You have to actually pay the cost in that year. For example, you incur \$10,000 three years in a row and you borrow the money from Uncle Bob; in year three you take out \$30,000 to pay off Uncle Bob – you only avoid the 10% penalty on the \$10,000 you actually paid that year.

12. The **transfer of assets** of a terminated defined benefit plan (participants' interests in which have been fully vested) to a 401k plan maintained by the same employer, which isn't considered an actual distribution from the terminated plan. The transferred amounts aren't taxable to the participants or former participants;
13. **Tax-free rollovers** (you have **60 days** to “roll over” a distribution from a retirement plan to another plan if you actually get a check) since the additional tax on early distributions applies only to the portion of a distribution that's includible in income.

As you can see, there are a lot of exceptions to the general rule that distributions taken prior to age 59 ½ are subject to a 10% penalty.

Please feel free to send me an email if you have any further questions.

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