

Retirement Plan Distributions Made Before Age 59-1/2

You probably know that qualified retirement plan or IRA distributions before you reach age 59 1/2 are subject to a 10% penalty tax in addition to any applicable income tax. This rule is to encourage savings for retirement, which is clearly a sound financial objective. But, sometimes financial circumstances make it necessary to withdraw retirement plan savings before age 59 1/2. If you must make an early withdrawal, there are some ways to avoid the 10% penalty. Also, if available, a qualified retirement plan loan can be structured as a nontaxable event, which would let you avoid a plan withdrawal and the 10% penalty tax.

Qualified Plan Distributions for Participants Age 55 or Older - A fairly narrow exception to the 10% penalty tax applies if you participate in a qualified retirement plan sponsored by your employer. If you are at least age 55 and terminate your employment, plan distributions are not subject to the penalty tax. The key is that you must both terminate employment and receive the distribution during the same year after reaching age 55 and before age 59 1/2 unless another exception applies. Surprisingly, the exception continues to apply even if you later go back to work for the same or a different employer. This exception can be used to plan for early retirement.

Substantially Equal Periodic Payments - A broader exception is available for qualified retirement plan participants and IRA owners. Regardless of your age, a series of "substantially equal" payments is not subject to the 10% penalty tax. However, distributions from a qualified retirement plan (not IRAs) are excepted only if you no longer work for that employer. The payment amount is determined by your life expectancy (i.e., is computed to deplete your account if you live to your anticipated life expectancy). However, the payments do not have to actually continue for your entire life. Instead, they can stop at the later of the date (1) you reach age 59 1/2 or (2) five years have elapsed. There are several methods for computing the payments, so it is possible to tailor payments to fit your financial needs.

Deductible Medical Expenses - Qualified retirement plan and IRA distributions up to the amount of your deductible medical expenses are not subject to the 10% penalty tax. This exception may be somewhat limited, however, since deductible medical expenses are only those over 7.5% of adjusted gross income. If your deductible medical expenses exceed that threshold, a penalty-free distribution can be made even if you don't itemize deductions.

Qualified Education Expenses - IRA (but not qualified retirement plan) distributions can also be made without incurring the 10% penalty

tax if they are used for qualified education expenses, which include tuition, fees, books, supplies, or required equipment for college (or certain postsecondary vocational schools). Expenses for room and board also qualify, up to a certain amount. The taxpayer, his or her spouse, children, stepchildren, or grandchildren can incur the expenses.

First-time Homebuyer Expenses - Finally, you can withdraw up to \$10,000 from an IRA (but not a qualified retirement plan) for first-time homebuyer expenses without incurring the 10% penalty tax. The distribution must be used to buy or build a principal residence for you or certain family members if the purchaser has not owned a home for at least two years. Reasonable settlement, financing, or other closing costs (i.e., points) are qualifying expenses.