Minimize Taxes and Penalties When You Face Early Retirement Withdrawals

Life doesn't always go according to plan. If you find yourself in a situation where you need to access the money in your retirement accounts earlier than you expected, it's important to understand the choices available to you.

Certain withdrawal strategies may be available to give you access to retirement savings and help you minimize tax impacts and IRS penalties, depending on the type of retirement savings accounts you own.

401(K) and Other Employer-Sponsored Retirement Plans

Plan Loans

Many employers allow employees to borrow from their own 401(k) account balances. Plan loans can be appealing not only because of the general ease and convenience in obtaining the loan, but also because you are borrowing from yourself and paying yourself back, plus interest. The interest rates are generally low and tied to the prime lending rate. Loan payments are usually made automatically from your pay check over five years (or longer if the loan is for the purchase of a home). However, failure to make timely loan payments or repay the outstanding loan balance if you leave your job or retire can be costly. If you default on the loan, you'll owe income taxes and a 10% IRS early withdrawal penalty may also apply on the balance you owe if you are younger than the age of 59½. Employers are not required to offer plan loans and provisions can vary from employer to employer.

Hardship Withdrawals

Hardship withdrawals are not loans and therefore cannot be repaid to the plan, but are a way to receive distributions from your retirement plan account balances for certain immediate and heavy financial needs. An employer is not required to offer hardship withdrawals to employees, but if they do there will be strict and detailed guidelines they will have to follow to ensure that there are no other means by which you can meet your financial need. Hardship withdrawals are subject to income tax and the 10% early withdrawal penalty if you are younger than age 59½.

In-Service, Non-hardship Withdrawals

Some employers will also allow you to withdraw a portion of your retirement account balances while working, without demonstrating a specific financial need. In-service, non-hardship withdrawals cannot be repaid to the plan and are subject to income taxes, the 10% early withdrawal penalty, and the 20% mandatory withholding requirement if not directly rolled over to an eligible retirement account.

"55 and Over" Exception

If you are or will be age 55 or older during the year you separate from service, distributions you receive from the retirement plan are not subject to the 10% early withdrawal penalty. However, distributions paid to you will be subject to mandatory 20% withholding and income taxes unless directly rolled over to an eligible retirement plan.

IRAs, SEPs and SIMPLEs

Roth IRAs

Roth IRAs offer a unique opportunity for access to your retirement savings. Roth IRA distributions are made in a specific order. First, your annual contributions are distributed and because your contributions to a Roth IRA are after-tax, you are able to withdraw up to the amount contributed at any time and for any reason without having to pay income taxes or IRS penalties. Next, if you funded a Roth IRA through a conversion of assets from a traditional IRA or employer-sponsored retirement plan, you may also withdraw up to the amount converted without paying taxes (because taxes were paid at the time of conversion). However, the 10% early withdrawal penalty will apply if you are younger than age 59½ and the converted balances are distributed in the first five years following the conversion. Under certain circumstances an exception to the 10% penalty may apply. Last, any earnings on your contributions that are withdrawn before the combination of five years and age 59½, will both be taxable and subject to the 10% penalty unless an exception applies.

Penalty-free IRA Withdrawals

The IRS considers all IRA withdrawals before the age of 59½ to be premature distributions. In addition to requiring you to pay income taxes on a premature IRA distribution, the IRS generally imposes an additional 10% penalty on the taxable amount. With SIMPLE IRAs, the penalty increases to 25% if the distribution is taken within the first two years of participation in the plan. However, there are certain circumstances when taxable premature IRA distributions are not subject to the penalty. Here are some of the exceptions that are available:

- **First-Time Home Purchase**. A first-time home purchase withdrawal cannot exceed $10,000 in your lifetime. To qualify for the first-time home buyer exception, you must not have owned a home for the two years prior to the purchase. The distribution must be used within 120 days and can be used for qualified acquisition costs for you, your spouse, children, grandchildren, parents or even grandparents.

- **Higher Education Expenses**. Distributions that are used for qualified higher education expenses for you, your spouse, your children, or grandchildren are not subject to the 10% penalty. Qualified higher education expenses include tuition, fees, books, supplies and limited amounts for room and board for students that are enrolled at least half-time at colleges, universities, vocational schools or other educational institutions that will qualify for financial aid programs administered through the Department of Education.

Other Penalty-Free Withdrawals from Both IRAs and Employer-Sponsored Retirement Plans

Substantially Equal Periodic Payments 72(t) Distributions

Unlike the penalty-free distributions discussed above which require the money to be used for a specific purpose, 72(t) distributions can be taken for any reason, but there are restrictions on the timing and the amount of the payments. The distributions must be substantially equal, made not less frequently than annually, determined using one of three IRS-approved methods, and be received for the longer of five years or until age 59½. The 72(t) distributions are taxable but are not subject to the early withdrawal penalty. With an IRA, payments can begin at any time, but if you have an employer-sponsored retirement plan, the payments cannot begin until after you separate from service.

Disability and Medical Expense Withdrawals

If you have a physical or mental disability which is expected to be of long, continued, or indefinite duration which keeps you from being able to work, or you have excessive unreimbursed medical expenses, you may also receive penalty-free access to your retirement accounts. Distributions for total and permanent disability are not limited. However, unreimbursed medical expenses must exceed 10% of your adjusted gross income (AGI) in order to qualify. In either case, the distributions will be subject to income taxes.

Because retirement savings accounts offer tax advantages that other savings account don't, make sure you have considered other possibilities first before taking a withdrawal from your 401(k) or IRA. Besides those discussed above, there are other exceptions that may also apply. Your Benjamin F. Edwards & Co. financial advisor can help you understand which alternatives are available to you. In addition to income taxes and penalties, the loss of tax-deferred growth is also a consideration you should review with your tax professional before taking an early retirement account withdrawal. ■