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EARLY WITHDRAWAL PENALTY EXCEPTIONS (PENALTY DOES NOT APPLY)

By Victor Sy, CPA

Exceptions That Apply To ALL Qualified Plans:

Unreimbursed Medical Expenses Exception: Amounts withdrawn to pay unreimbursed medical expenses that would be deductible on Schedule A during the year and that exceed 7.5% of the taxpayer's AGI are exempt from penalty. This is true even if the taxpayer does not itemize.

Disabled Exception: If a taxpayer becomes disabled before reaching age 59-1/2, any amounts withdrawn because of the disability are not subject to the 10% additional tax. A taxpayer is considered disabled if the taxpayer can furnish proof that he/she cannot perform any substantial gainful activity because of the physical or mental condition. A physician must determine that the taxpayer's condition:

- Can be expected to result in death, or
- Is expected to be of a long, continued and indefinite duration.

Beneficiary Exception: If a taxpayer dies, the benefits distributed to a taxpayer's beneficiary or estate are exempt from the early withdrawal penalty. *Caution:* If a decedent's spouse chooses to treat the distribution as his/her own and later receives a distribution before reaching age 59-1/2, it may be subject to the penalty.

Annuity or "Substantially Equal Payments" Exception : This exception essentially allows a taxpayer to retire early and take withdrawals before reaching age 59-1/2. For qualified plans, this exception applies only for distributions that begin after the taxpayer separates from service. To qualify for this exception, the payments:

- Must be part of a series of substantially equal payments over the taxpayer's life, or the joint life expectancies) of taxpayer and the taxpayer's beneficiary, and
- Payments under this exception must continue for at least 5 years, or until the taxpayer reaches age 59-1/2, whichever is the longer period. This 5-year rule does not apply if a change from an approved distribution method is made because of the death or disability of the IRA owner.

Distribution as result of an IRS Levy: The 10% penalty tax on early withdrawals does not apply to withdrawals from a qualified plan or IRA made on account of a levy under Code Sec. 6331 on the plan or IRA. This exception applies to post-1999 distributions only if the qualified plan or IRA is actually levied on. The 10% penalty tax still applies if the taxpayer withdraws amounts from a qualified plan or IRA to pay taxes in the absence of a levy, or even if the taxpayer makes a plan or IRA withdrawal in order to cause the IRS to release a levy on a separate property interest of the taxpayer.

Pension Plan Garnishment : IRS has privately ruled that qualified retirement plans won't be disqualified for paying some participants' and beneficiaries' benefits to satisfy their criminal fines under garnishment orders relating to federal criminal statutes. IRS also concluded that the distributions would not be subject to the 10% early withdrawal penalty tax, mandatory withholding or written notice requirements. In another ruling, IRS privately held that a federal court seeking to collect a fine in an individual's criminal case would not violate the anti-alienation rule by garnishing the individual's Code Sec. 401(k) plan account balance. However, that ruling did not address the 10% additional tax, or whether the payments would be subject to mandatory withholding.

Qualified Reservist Distributions: The 10% early withdrawal penalty tax does not apply (retroactively) to a "qualified reservist distribution." A qualified distribution is:

- From an IRA or attributable to elective deferrals under a 401(k) plan, 403(b) annuity, or certain similar plans;
- Made to individuals who (because of their being members of a reserve component) are ordered or called to active duty after Sept. 11, 2001, for a period of more than 179 days or for an indefinite period; and
- Made during the period from on the date of the order or call to duty to the close of the active duty period.

Exceptions That Apply To IRA ONLY

Contributions Returned Before the Due Date: If the taxpayer made an IRA contribution for the tax year, it can be withdrawn tax-free by the extended due date of the tax return provided:

- Taxpayer did not take a deduction for the contributions withdrawn, and
- The taxpayer also withdraws any interest or other income earned on the contributions, and
- The taxpayer reports for the year in which the withdrawal was made, any earnings on the withdrawals.

Medical Insurance Exception: This exception allows taxpayers that qualify to make penalty-free withdrawals to pay for medical insurance. The amount that is exempt from penalty cannot be more than the amount paid during the year for medical insurance for taxpayer, spouse, and dependents. To qualify for this exception, the taxpayer:

- Must have lost his/her job,
- Received unemployment compensation for 12 consecutive weeks,
- Made withdrawals during the year he/she received unemployment **or** in the following year, and
- Made the withdrawals no later than 60 days after being reemployed.

Higher Education Expense Exception: Withdrawals made during the year for qualified higher education expenses for the taxpayer, spouse or children or grandchildren of the taxpayer or spouse are exempt from the early withdrawal penalty. The part not subject to the tax is generally the amount that is not more than the qualified higher education expenses for the year at an eligible educational institution.

First-Time Homebuyer Exception: To qualify for treatment as a first-time homebuyer distribution, the distribution must meet *all* the following requirements:

- It must be used to pay qualified acquisition costs before the close of the 120th day after the day the distribution was received.
- It must be used to pay qualified acquisition costs for the main home of a first-time homebuyer of the:
  - Taxpayer, taxpayer's spouse
  - Taxpayer or spouse's child or grandchild
  - Taxpayer or spouse's parent or other ancestor
- When added to all the taxpayer's prior qualified first-time homebuyer distributions, if any, the total distributions cannot be more than $10,000. Two (or more) individuals *together* purchase a home for the first time. But it's probably permissible for a husband and wife purchasing their first home together *can* each withdraw up to $10,000 from each of their respective IRAs without incurring any penalty for early withdrawal.

Exceptions That Apply To Qualified Plans OTHER Than IRA

QDRO Distributions Exception: Distributions from a qualified retirement plan to an alternate payee under a qualified domestic relations order. *Caution:* If a recipient rolls the distribution into his/her own IRA account, any subsequent distribution will be subject to the early withdrawal penalty, unless any of the other exceptions applies.

Separation from Service: Distributions from a qualified retirement plan after separation from service in or after the year the taxpayer reached age 55 (see below for a special rule for certain public safety employees).
TIP: Distributions of this type are rarely coded on Form 1099-R as an early distribution. This exception applies only where the taxpayer separates from employment after reaching age 55. The Tax Court ruled the exception did not apply in the case of a taxpayer who retired from his job when he was age 53 but who waited until after he turned 55 to make a withdrawal from his qualified retirement plan. A taxpayer must be age 55 or older, and then separate from employment, for an early distribution to be excepted from the 10% penalty.

Public safety employees not subject to 10% penalty tax:
The 10% early withdrawal tax does not apply to post-August 17, 2006 distributions from a governmental defined benefit pension plan to a qualified public safety employee who separates from service after age 50. A qualified public safety employee is an employee of a State (or political subdivision) who provides

- Police protection,
- Firefighting services, or
- Emergency medical services for any area within the jurisdiction of the State or political subdivision.