



Want to Retire Early? How to Avoid the 10% Penalty

By Sean Cote, AIF®

Many people dream of retiring early or reducing their work hours prior to retirement. If you hope to retire before age 59½, you need to be aware that the Internal Revenue Service imposes a stiff penalty for withdrawing money early from your retirement savings.

Retirement savings held in an IRA or a qualified retirement plan through your employer are subject to an additional 10% tax - on top of the ordinary income tax you pay - on distributions taken prior to age 59½. The IRS imposes this penalty to discourage the use of retirement savings for purposes other than normal retirement.

With careful planning, you can take certain types of distributions and avoid the 10% penalty. Consult your tax advisor to learn more about the exceptions described briefly below.

Substantially Equal Periodic Payments

This option allows you to take distributions from your retirement plan in equal annual installments. The periodic payments are calculated to be spread out over the life expectancies of the owner and beneficiary of the account. The total value of your account will have a major impact on the calculation of your periodic payments. Once you begin taking these distributions, you are committed to continue. If you modify the payment amount within 5 years or before turning 59½, the 10% penalty will be applied retroactively to all previous distributions.

The substantially equal periodic payment option is available for retirement plan accounts and IRAs, regardless of the age of the owner. If you take this type of distribution from a retirement plan account, you must fully separate from service to that employer. If the payments are from an IRA, your employment status is irrelevant.

Separation of Service After Age 55

If you leave your employer after age 55, you will not have to pay the 10% penalty on any distributions you receive from your former employer's retirement plan, as long as you are no longer working for that employer. If you return to that employer at a later date and you're under age 59½, you are not able to take distributions from that plan. Note that you do not have to be retired to qualify for the age 55 exception; you can be working for another employer and take distributions from your previous employer's plan without penalty.

In the event you separate from service before the year you turn 55 - and wish to take distributions from the employer-sponsored plan prior to age 59½ - those distributions will be subject to the 10% penalty.

The age-55 exception does not apply to IRAs. Be cautious of rolling 401(k) accounts and other employer-sponsored plans into IRAs if you separated from service between the year you turned 55 and age 59½. Once an employer-sponsored account is rolled into an IRA, the age-55 exception cannot apply to distributions.

Other Exceptions

Other types of distributions for both IRAs and retirement plans - unrelated to early retirement - are not subject to the 10% penalty prior to age 59½. These include distributions that are:

- Made to your beneficiary or estate on or after your death.
- Made because you are totally and permanently disabled.
- Equal to or less than your deductible medical expenses.

Exceptions that apply only to distributions from IRAs include distributions that are:

- Equal to or less than your qualified higher education expenses.
- Made to pay for a first-time home purchase.
- Used to pay health insurance premiums if you are unemployed.

Keep in mind that any distribution from a qualified retirement plan or IRA that is funded with pre-tax contributions is subject to ordinary income taxes. If you are considering an early distribution from a retirement plan, consult with a tax advisor prior to making your decision.

The IRS Web site, www.irs.gov, is a good resource for additional information regarding this topic. Early distribution information can be found by referencing tax topic 558.

For more information or to contact Sean Cote, please visit the Our Professionals page of www.svawealth.com.

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