Avoiding the 10% Penalty

…in 5 Easy Steps

What is the 10% penalty? A 10% early distribution penalty applies to taxable distributions made before age 59 ½. Distributions made after age 59 ½ are not subject to the 10% early distribution penalty.

Exceptions: Exceptions apply for withdrawals from company retirement plans for individuals who separate from service at age 55 or older, and for withdrawals from governmental defined contribution and defined benefit plans for public safety officials who separate from service at age 50 or older. For SIMPLE IRAs, the penalty is 25% for the first two years in the plan, then reverts back to the 10% penalty in following years.

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Sean is a member of Ed Slott's Elite IRA Advisor Group℠, an exclusive organization of financial advisors who are dedicated to being leaders in the IRA industry. As an Ed Slott Elite IRA Advisor, Sean proves to be an advisor with the specialized knowledge to navigate an increasingly more complicated tax environment.

1. **For distributions before age 59 ½, look for an exception to the penalty.** The main exceptions are disability, death (distributions to beneficiaries are never subject to the penalty), medical expenses generally in excess of 10% of AGI (adjusted gross income) in the year of distribution, first-time homebuyers, higher education expenses, qualified birth or adoption expenses an IRS levy and health insurance for the unemployed receiving unemployment compensation for 12 consecutive weeks.

2. **Make sure the exception you want to use applies to the type of plan you have.** There are three categories of exceptions to the 10% early distribution penalty. Some exceptions apply to both IRAs and employer plans, some apply to IRAs only, and some apply to employer plans only. Be sure you use the right exception for your type of retirement account.

3. **The expense must be in the same year as the IRA distribution.** For exceptions such as the higher education expense and the medical expense, make sure the IRA distribution is made in the same year the expense is incurred.

4. **Some exceptions apply when the distribution is used for a family member.** Exceptions such as death and disability only apply to the account owner. Other exceptions apply to family members such as spouses, children or grandchildren. Check with your financial advisor to find out the requirements of any exception for which you think you might qualify.

5. **How to claim an exception.** Many times the IRA custodian or plan administrator will issue the 1099-R for the distribution with a code saying that the distribution is early and no known exception applies. Don't give up. You should file IRS Form 5329 with your tax return to tell the IRS what exception you are claiming.

Distributions from traditional IRA's and employer sponsored retirement plans are taxed as ordinary income and, if taken prior to reaching age 59 ½, may be subject to an additional 10% IRS tax penalty.