

Looking for Quick Cash? Try to Avoid Retirement Savings

Article Highlights:

- Early-Withdrawal Penalties
- Reduction in Retirement Savings
- Exceptions from the Early-Withdrawal Penalty

If you find yourself looking for a quick source of cash, your retirement savings may look like a tempting option. However, if you are under age 59½ and withdraw money from a traditional IRA or qualified retirement account, you will likely pay both income tax and a 10% early-distribution tax (also referred to as a penalty) on any previously untaxed money that you take out. Withdrawals you make from a SIMPLE IRA before age 59½ and those you make during the 2-year rollover restriction period after establishing the SIMPLE IRA may be subject to a 25% additional early-distribution tax instead of the normal 10%. The 2-year period is measured from the first day that contributions are deposited. These penalties are just what you'd pay on your federal return; your state may also charge an early-withdrawal penalty in addition to the regular state income tax.

Thus, before making any withdrawals from an IRA or other retirement plan—including a 401(k) plan, a 403(b) tax-sheltered annuity plan, or a self-employed retirement plan—carefully consider the resulting decrease in retirement savings and increase in taxes and penalties.

There are several exceptions to the 10% early-distribution tax; these depend on whether the money you withdraw is from an IRA or a retirement plan. However, even if you are not subject to the 10% penalty, you will still have to pay taxes on the distribution.

The SECURE 2.0 Act, passed by Congress and signed into law by the President in December of 2022, added several new exceptions. The following exceptions may help you avoid the penalty; the first 2 are new.

- **Exception for Terminal Illness** - This applies in the case of a distribution from a qualified plan to an employee who is terminally ill on or after the date on which the employee has been certified by a physician as having a terminal illness which can reasonably be expected to result in death in 84 months or less after the date of the certification.
- **Penalty Exception for Domestic Abuse** - A domestic abuse survivor may need to access his or her money in their retirement account for various reasons, such as escaping an unsafe situation. Retirement plans can permit participants that self-certify that they experienced domestic abuse to withdraw a small amount of money not subject to the 10% early withdrawal penalty and not to exceed the lesser of:
 - o \$10,000, or
 - o 50% of the present value of the nonforfeitable accrued benefit of the employee under the plan.

A distribution is an eligible distribution if it is made during the 1-year period beginning on any date on which the individual is a victim of domestic abuse by a spouse or domestic partner.

Domestic abuse means physical, psychological, sexual, emotional, or economic abuse, including efforts to control, isolate, humiliate, or intimidate the victim, or to undermine the victim's ability to reason independently including by means of abuse of the victim's child or another family member living in the household.

A distribution in this case may be repaid at any time during the 3-year period beginning on the day after the date on which the distribution was received.

- **60-Day Rollover to Another Qualified Plan** – A taxpayer can avoid both the income tax and the penalty on an early distribution if the distribution is rolled over into an eligible retirement plan within 60 days of receipt.

Some taxpayers use the 60-day rollover provision as a source for a short-term loan. However, there are built-in hazards for the 60-day rule:

- o One rollover per 12 months rule – IRA rollovers are limited to one per 12-month period. Any other than the one would be considered a taxable distribution unless another exception applies.
- o Twenty percent withholding rule – Another barrier to completing a 60-day rollover is the mandatory 20% withholding of federal income tax requirement when a qualified plan distribution isn't transferred trustee-to-trustee. Because 20% of the distribution went to withholding tax, the taxpayer only received 80% of the funds and cannot recoup the withholding until filing time. Thus, they would have to make up the 20% from other sources to complete a 100% rollover.

A distribution from a qualified retirement plan or IRA that is transferred directly by the trustee of the plan to the trustee of another qualified plan or to another IRA does not count as a rollover and does not trigger the once-per-year rollover limitation and are not subject to withholding.

- **Withdrawals from any retirement plan to pay medical expenses**—Amounts withdrawn to pay unreimbursed medical expenses are exempt from penalty if they would be deductible on Schedule A during the year and if they exceed 7.5% of your adjusted gross income. This is true even if you do not itemize.
- **Withdrawals from any retirement plan because of a disability**—You are considered disabled if you can furnish proof that you cannot perform any substantial gainful activities because of a physical or mental condition. A physician must certify your condition:
 - o Can be expected to result in death, **or**
 - o Is expected to be of a long, continued, and indefinite duration.
- **IRA withdrawals by unemployed individuals to pay medical insurance premiums**—The amount that is exempt from penalty cannot be more than the amount you paid during the year for medical insurance for yourself, your spouse, and your dependents. You also must have received unemployment compensation for at least 12 consecutive weeks during the year.
- **Childbirth and Adoption**—For distributions after 2019, a distribution to an individual is exempt if made during the one-year period beginning on the date on which a child of the individual is born, or the date on which the legal adoption of an eligible adoptee is finalized. The maximum amount exempt from penalty is \$5,000, and the amount applies to each spouse separately. Such qualified birth or adoption distributions may be recontributed to an individual's applicable eligible retirement plans within three years subject to certain requirements.
- **IRA withdrawals to pay higher education expenses**—Withdrawals made during the year for qualified higher education expenses for yourself, your spouse, or your children or grandchildren are exempt from the early-withdrawal penalty.
- **IRA withdrawals to buy, build, or rebuild a first home**—Generally, you are considered a first-

time homebuyer for this exception if you had no present interest in a main home during the 2-year period leading up to the date the home was acquired, and the distribution must be used to buy, build, or rebuild that home. If you are married, your spouse must also meet this no-ownership requirement. This exception applies only to the first \$10,000 of withdrawals used for this purpose. If married, you and your spouse can each withdraw up to \$10,000 penalty-free from your respective IRA accounts.

- **IRA withdrawals annuitized over your lifetime**—To qualify, the withdrawals must continue unchanged for a minimum of 5 years, including after you reach age 59½.
- **Separation from Service** —To qualify, you must be separated from service and be age 55 or older in that year (the lower limit is age 50 for qualified public-service employees such as police officers and firefighters) or elect to receive the money in substantially equal periodic payments after your separation from service. After 2022 this exception also applies to private sector firefighters.
- **Emergency Expenses Withdrawal** – The 10% penalty will not apply to certain distributions used for emergency expenses, which are unforeseeable or immediate financial needs relating to personal or family emergency expenses. Only one distribution is permissible per year of up to \$1,000, and a taxpayer has the option to repay the distribution within 3 years. No further emergency distributions are permissible during the 3-year repayment period unless repayment occurs. **CAUTION: This exception is not effective until after 2023.**

You should be aware that the information provided above is an overview of the penalty exceptions, and that conditions other than those listed above may need to be met before qualifying for a particular exception. You are encouraged to contact this office before tapping your retirement funds for uses other than retirement. Distributions are most often subject to both normal taxes and other penalties, which can take a significant bite out of them. However, with carefully planned distributions, both the taxes and the penalties can be minimized. Please call for assistance.