



Financial Services, LLC

33 South Commercial Street
Manchester, New Hampshire 03101
Tel: 603-641-1010
Fax: 603-641-0707
e-mail: fdemaio@jtdfinancial.com
www.jtdfinancial.com

EARLY DISTRIBUTIONS FROM RETIREMENT ACCOUNTS

Some tax consequences to remember.

Provided by Frank DeMaio

There are times when people really need money - and in those times, a retirement account may seem like a conveniently liquid resource to tap. What's the harm in taking an early distribution from a tax-deferred retirement plan? Well, the tax bite could be considerable.

Big taxes may await you. If you are younger than 59½, working, and you withdraw funds from your 401(k) or IRA just as you would from a bank account, you might really feel the pain next April. An early distribution from an IRA or a qualified retirement plan must usually be included in your taxable income. So your federal tax bill could balloon for the year in which you take the distribution. (If you take an early distribution from a Roth IRA, you won't be taxed on the amount of your contributions. Any amount above that which is attributable to the Roth IRA's earnings will be subject to tax.)¹

An additional 10% tax penalty may also apply. The federal government really, really doesn't want taxpayers to raid their Roth and traditional IRAs, 401(k)s and 403(b)s when they are far from retirement age, so an additional 10% early withdrawal penalty is in place to further discourage premature distributions.¹

There are some exceptions to this. This 10% penalty may not apply if you are using the money you withdraw to pay for

- Deductible medical expenses (documented medical expenses that exceed 7.5% of your adjusted gross income).
- Higher education expenses (for you, your spouse, or children or grandchildren either of you may have).
- The purchase of your first home, or the building or rebuilding of a first home.^{2,3}

You are also exempt from the 10% penalty on premature distributions if you are "totally and permanently" disabled, in the words of IRS Publication 575.²

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Another notable exception: the 10% penalty on early distributions does not apply if you are the beneficiary of a deceased IRA owner. If a traditional IRA owner dies before age 59½, neither the owner's estate nor the beneficiary will face the 10% early distribution penalty when those IRA assets are distributed. However, if your spouse dies and you decide to treat an IRA you inherit from him or her as your own, any distribution you take from it before you reach age 59½ may be subject to the 10% penalty.³

Do you really want to do this? As you can see, an early distribution from an IRA or a qualified retirement plan may amount to some very expensive money. It also reduces the invested assets within that retirement account - assets that could potentially grow and compound mightily over time.

This is why financial consultants may commonly warn their clients against making such a move. Sometimes couples and families feel they have no choice but to draw down their retirement savings, but a conversation with the financial services professional they know and trust may reveal other options.

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Citations.

1 - advisorone.com/article/irs-top-10-tax-facts-about-early-distributions-retirement-plans [3/2/11]

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