

# **PRE-59½ DISTRIBUTIONS – CAREFUL ANALYSIS IS REQUIRED**

**BY: DIANE M. PEARSON, CFP**



5700 Corporate Drive, Suite 350  
Pittsburgh, Pennsylvania, 15237

Phone: (412) 635-9210  
Fax: (412) 635-9213

Email: [legend@legend-financial.com](mailto:legend@legend-financial.com)  
Web: [www.legend-financial.com](http://www.legend-financial.com)

## **PRE-59½ DISTRIBUTIONS – CAREFUL ANALYSIS IS REQUIRED**

**BY: DIANE M. PEARSON, CFP**

As more and more retirement account owners are either forced out or voluntarily opt out of employment into early retirement, pre-59½ distribution planning from Individual Retirement Accounts (IRAs) and retirement plans becomes increasingly important. Expertise in this area of the tax code is critical to avoid unsuspectingly triggering the numerous penalties associated with a pre-59½ withdrawal.

Distributions from an IRA or retirement plan prior to age 59½, also known as premature distributions, are normally subject to tax as ordinary income. Furthermore, premature distributions are subject to an additional tax equal to 10% of the amount of the taxable distribution as a penalty. This penalty tax is increased to 25% if premature distributions are made from a Savings Incentive Match Plan for Employees (SIMPLE) IRA account.

Please note that the early distribution rules apply to traditional IRAs and in a similar fashion to the qualified plans, with a few exceptions, which are noted with each applicable rule.

When does the 10% penalty not apply? The following exemptions are listed of the various circumstances for pre-59½ distributions that are not penalized:

- 1. Death** - if the deceased was under age 59½ and receiving distributions and the beneficiary leaves the plan in the deceased's name and continues to take distributions based on the distribution method that had been started.

What if distributions hadn't started? If a surviving spouse under the age of 59½ is the beneficiary, and elects to re-register the IRA in his or her own name as an IRA Rollover and begins to take distributions, that distribution will be subject to the 10% penalty. The 10% penalty can be avoided

by the surviving spouse taking payments based on the IRC Section 72(t) methods (Substantially Equal Periodic Payments) described below or by the surviving spouse taking a lump sum from the account and rolling over the balance to an IRA Rollover. The lump sum that is distributed is taxable as income because it is a distribution due to death, but it is not subject to the 10% penalty tax. The remaining portion can then be rolled over to an IRA Rollover account and avoids taxation. The remaining portion also does not incur the 10% penalty tax. The surviving spouse can then retitle the IRA Rollover account into his or her own name and all rules would apply as though the surviving spouse is the original owner.

If the beneficiary is not a spouse the IRA cannot be rolled over into the beneficiary's name. The IRA must be kept in the deceased's name. The non-spousal beneficiary has two options on how to receive the assets. The first is to take distributions over their own life expectancy. The second option is to deplete the assets by December 31 of the fifth year following the retirement plan owner's death.

- 2. Disability** - If the IRA or retirement plan participant, who is under the age of 59 ½, becomes disabled the 10% penalty tax is avoided on all distributions. IRC Section 72(m)(7) defines "disabled" as "unable to participate in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration".
  
- 3. Separation from Service after age 55** - The 10% penalty tax does not apply to distributions from a qualified retirement plan made to an employee who has attained the age of 55, who has separated from service and has attained the age of 55, or to certain employees who were separated from service as of March 1 1986 and leave their retirement monies with their employer. The retirement account owner may be employed by another organization/company or even return to work for the same employer at a later date. If using the age 55 exception to the early distribution tax, the retirement account owner cannot receive a distribution from the employer's

retirement plan while still employed with the company. The retirement plan owner does not need to be age 55 on the separation date, as long as he is 55 or older by December 31 of the separation year. This rule does not apply to IRA distributions, only to distributions from qualified retirement plans. Qualified retirement plans do not include Simplified Employee Pensions (SEPs) and Savings Incentive Match Plans for Employees (SIMPLEs). Therefore, the monies must remain in the employer's plan. Distributions can be stopped and started and do not have to be substantially equal periodic distributions nor do they have to continue for any length of time. Please keep in mind that employers are not required to make this feature available to plan participants.

4. **Qualified Domestic Relations Orders** - The 10% penalty tax is avoided if distributions are being made to an alternate payee under a Qualified Domestic Relations Order (QDRO). A QDRO usually arises from a separation or divorce agreement and involves payments for child support or alimony. It does apply to an IRA transfer, but does not apply to normal IRA distributions. A normal IRA distribution is one that is taken after age 59½.
  
5. **Medical Needs** - The 10% penalty tax is avoided if distributions are made for medical care, but only for amounts in excess of 7.5% of the taxpayer's adjusted gross income (AGI). Also, the medical expense exception is available even if the retirement plan owner does not itemize deductions. It applies to the amounts that would be deductible if itemized. If the distribution is from a traditional IRA, the following conditions must be satisfied to avoid the penalty:
  - a. Unemployment compensation must be received for at least twelve (12) weeks;
  - b. The distribution from the IRA must occur in the year or during the following year in which unemployment compensation is received; and
  - c. The IRA distribution is received no more than sixty (60) days after returning to work.

- 6. Medical Insurance Premiums** - Retirement account owners who have received unemployment compensation for at least twelve (12) consecutive weeks are allowed penalty-free withdrawals from an IRA without regard to the 7.5% AGI deduction floor when they use the funds to pay for medical insurance premiums.
- 7. Excess Retirement Plan Contributions** - No 10% penalty tax is imposed on refunds made to reduce an excess contribution to a retirement plan. The excess contribution must come out of the plan within a set period of time (usually prior to filing a tax return). This rule does not apply to traditional IRA distributions.
- 8. Excess Elective Deferrals To A Retirement Plan** - The 10% penalty tax is also avoided if distributions are made to reduce an excess elective deferral to a retirement plan. This rule does not apply to traditional IRA distributions.
- 9. Dividends Paid With Respect To Employee Stock Ownership Plans (ESOPs)** - If distributions represent dividends paid with respect to Employee Stock Ownership Plans (ESOPs), the 10% penalty tax does not kick in, no matter when the dividend is received. This rule does not apply to traditional IRA distributions.
- 10. Distributions Used To Pay For Qualified Higher Education Expenses** - The 10% penalty tax does not apply to distributions to pay for "Qualified Higher Education Expenses" during the taxable year for the taxpayer, the taxpayer's spouse, or the child or grandchild of the taxpayer. "Qualified higher education expenses," include tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the student at any eligible educational institution (but not amounts contributed to a qualified state tuition program or room and board).
- 11. Qualified First-Time Home Buyers** - The 10% penalty tax does not apply to distributions that are for "Qualified First-Time Home Buyers". These distributions are defined as any payments or

distributions that are used within 120 days after the date that they were received by the retirement account owner to pay qualified acquisition costs of a principal residence for a first-time homebuyer or the first home of a spouse, child, grandchild or ancestor. The distribution is subject to a \$10,000 lifetime limit.

**12. Roth IRA Rollover Conversions From Qualified Retirement Plans** - The 10% penalty does not apply for a Roth IRA conversion. Monies from a qualified retirement plan cannot be transferred directly to a Roth IRA; the plan must be transferred first to an IRA Rollover account and then to a Roth IRA Rollover account. A regular IRA or IRA Rollover may be converted to a Roth IRA or Roth IRA Rollover respectively, directly. The taxes due on the conversion must be paid in full in the year of conversion. Once the Roth conversion has occurred, distributions cannot be taken for the first five (5) years without a 10% penalty tax.

**13. Substantially Equal Periodic Payments** - The 10% penalty tax may be avoided if the retirement account owner chooses to take “substantially equal periodic payments” under the rules of IRC Section 72(t) and IRS Notice 89-25 dated March 20, 1989. The following rules must be adhered to:

- a. payments must be substantially equal;
- b. payments must be taken at least annually;
- c. payments must not exceed the Retirement account owner’s life expectancy; and
- d. payments may not be modified until age 59½ or for five (5) years, whichever is greater.

**Non-Aggregation of IRAs:**

The IRS does not require a retirement account owner to aggregate their IRA or retirement plan accounts in order to take payments prior to age 59½. If a retirement account owner only needs to take withdrawals from a portion of his IRA account, the account can be separated into multiple accounts. This splitting of the IRA rollover account will permit the retirement account owner to target payments for only the amount

actually needed without creating a need to withdraw funds from the entire IRA rollover. This will allow the other IRAs or retirement plan accounts to continue to grow until the age of 70½, at which time mandatory minimum distributions must begin (except for Roth IRAs and Roth IRA rollovers).

**Summary:**

In summary, taking distributions prior to age 59½ from retirement plans and IRAs without the 10% penalty tax is possible, but tricky. A thorough knowledge of the tax laws, understanding how to analyze the various distribution methods and an excellent understanding of the various strategies in pre-59½ distribution planning is the key to avoiding unnecessary tax and interest penalties.

Diane M. Pearson, CFP, is a Financial Advisor and shareholder of Legend Financial Advisors, Inc. Ms. Pearson has been selected by **Worth** magazine in their September, 2001 issue as one of the “**250 Best Financial Advisors in America**”. Legend Financial Advisors, Inc. is a fee-only Securities and Exchange Commission registered investment advisory firm with headquarters located in Pittsburgh, Pennsylvania. Legend provides Wealth Advisory Services, including Comprehensive Financial Planning and Investment Management to affluent and wealthy individuals as well as business entities.