



Retirement Planning

IRAs: What You Need to Know about the 10% Early Distribution Penalty

The penalty kicks in if you tap your IRA before you reach age 59½—but there are a number of key exceptions to the rule.



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Individual retirement accounts (IRAs) are tax-advantaged vehicles designed to be used as an income source throughout your retirement years. Should you need money sooner, however, you can withdraw such funds at any age and/or time. Ideally, to maximize savings, you should not withdraw these funds before reaching retirement. However, things may occur that are beyond your control, and you may need income, leaving you no choice but to tap your IRA funds earlier than planned.

Accessing those funds early comes at a cost. In most cases, withdrawing funds before attaining age 59½ will be taxable (federal plus state, if applicable), and you will also be subject to a 10% early distribution penalty tax, unless certain conditions apply.

Currently, there are more than 20 exceptions to the 10% early distribution penalty tax. Importantly, some exceptions apply only to IRAs, whereas others apply to workplace retirement plans (i.e., 401(k)s), and lastly, some apply to both. For example, exceptions available only to IRAs (including SEP and SIMPLE IRA), are higher education expenses, funds used to purchase a first home, and health insurance expenses, if you are unemployed. Exceptions applicable to both employer-sponsored plans and IRAs include death, disability, Section 72(t), and medical expenses amounting to more than 7.5% of adjusted gross income.

We will discuss each individual exception including several new ones included in Secure Act 2.0 in our next column. But for now, we'll focus on aspects of the 10% early distribution penalty tax. Here are some important points to know:

- When an individual below age 59½ takes a withdrawal from his or her IRA or an employer-sponsored retirement plan (i.e., 401(k), 403(b)), a 10% early withdrawal penalty tax applies unless an exception is satisfied. The funds are also generally included in taxable income.
- If you're due to turn age 59 ½ later this year (2025) but take an IRA distribution earlier (prior to your 59½ birthday), your distribution will generally be subject to the 10% penalty tax. In other words, avoiding such penalty requires that an IRA owner take a distribution after their 59½ birthday.
- The 10% penalty tax applies only to the taxable portion of your traditional IRA distribution. Whereas any distribution of after-tax funds (basis) from a traditional IRA would not be subject to such a penalty or income tax. IRA basis is reported on IRS [Form 8606](#) "Nondeductible IRAs."
- The 10% penalty tax generally applies only to the taxable portion (i.e., earnings) of a distribution from a Roth IRA. Notably, such penalty also applies to [a distribution of converted funds](#) taken within five years from the year of a conversion (known as the "recapture tax"). The penalty would apply even though the Roth IRA distribution would not be subject to taxation because such taxes were previously paid in the year of the Roth IRA conversion.



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- Distributions from an inherited IRA are never subject to the 10% penalty tax. This holds true even if both the IRA owner (now deceased) and his/her beneficiary are under age 59 ½.

Tax Reporting

When you take a distribution from your retirement account, your IRA custodian sends you and the Internal Revenue Service (IRS) a copy of Form 1099-R "Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc." reporting your distribution. In addition to showing the distribution amount, [Form 1099-R](#) will reveal the distribution type.

Furthermore, there is a code (code 2) that indicates whether there is a known exception to the 10% penalty tax indicating your distribution is not subject to this additional penalty tax. However, IRA custodians are not usually aware of whether you qualify for an exception. Therefore, in most cases, the 1099-R (that you receive) will indicate that there is no known exception to your distribution (code 1). Therefore, it's up to you (or your accountant) to notify the IRS the 10% penalty tax doesn't apply.

How do you report that the 10% federal penalty tax doesn't apply to your distribution? File IRS [Form 5329](#) "Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts" along with your tax return.

Questions? Please contact your Lord Abbett representative at 888-522-2388.



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Examples are for illustrative purposes only; actual results may vary and differ for each individual.

A **401(k) plan** is a qualified plan that includes a feature allowing an employee to elect to have the employer contribute a portion of the employee's wages to an individual account under the plan. The underlying plan can be a profit-sharing, stock bonus, pre-ERISA money purchase pension, or a rural cooperative plan. Generally, deferred wages (elective deferrals) are not subject to federal income tax withholding at the time of deferral, and they are not reported as taxable income on the employee's individual income tax return.

A **403(b) plan**, also known as a tax-sheltered annuity plan, is a retirement plan for certain employees of public schools, employees of certain Code Section 501(c)(3) tax-exempt organizations and certain ministers. A 403(b) plan allows employees to contribute some of their salary to the plan. The employer may also contribute to the plan for employees.

Plans of deferred compensation described in IRC section 457 are available for certain state and local governments and non-governmental entities tax exempt under IRC Section 501. They can be either eligible plans under IRC 457(b) or ineligible plans under IRC 457(f). Plans eligible under 457(b) allow employees of sponsoring organizations to defer income taxation on retirement savings into future years.

A **SIMPLE IRA** is a retirement plan that may be established by employers, including self-employed individuals. The employer is allowed a tax deduction for contributions made to the SIMPLE. The employer makes either matching or nonelective contributions to each eligible employee's SIMPLE IRA, and employees may make salary deferral contributions.

Traditional IRA contributions plus earnings, interest, dividends, and capital gains may compound tax deferred until you withdraw them as retirement income. Amounts withdrawn from traditional IRA plans are generally included as taxable income in the year received and may be subject to 10% federal tax penalties if withdrawn prior to age 59½, unless an exception applies.

A **Roth IRA** is a tax-deferred and potentially tax-free savings plan available to all working individuals and their spouses who meet the IRS income requirements. Distributions, including accumulated earnings, may be made tax free if the account has been held at least five years, and the individual is at least 59½, or if any of the IRS exceptions apply. Contributions to a Roth IRA are not tax deductible, but withdrawals during retirement are generally tax free.

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