Retirement Planning

401(k) Plans and IRAs: Exceptions to the 10% Early Distribution Penalty

Here's a guide to the currently available exceptions to the standard penalty on early distributions from certain retirement accounts.

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Retirement account funds are designed to be spent during your retirement years.

Distributions made from a qualified retirement plan or IRA before age 59½ are generally subject to taxation plus a 10% early distribution penalty. Congress created this penalty to discourage account owners and plan participants from accessing their funds before their retirement.

Here are the details: Internal Revenue Code (IRC) Section 72(t)(1) imposes a 10% early distribution penalty tax on a distribution from qualified retirement plans (i.e., 401(k), 403(b, profit sharing, defined benefit, cash balance, etc.) and IRAs (including SEP and SIMPLE IRAs) unless the distribution qualifies for an exception under IRC Section 72(t)(2). (Notably, distributions made from a SIMPLE IRA within the first two years of participation incur a 25% early distribution penalty tax instead of 10%.)

But Congress also recognized that sometimes there can be a financial need to access retirement funds early, so lawmakers created exceptions to the early distribution penalty. Unfortunately, some exceptions apply only to IRAs, whereas some apply just to qualified retirement plans. Lastly, some apply to both distributions from both IRAs and qualified retirement plans.

There are currently more than 20 exceptions, with a new one becoming effective later this year, which applies to premium payments for long-term care policies and only to employer-sponsored plans. Here is a brief guide to the currently available exceptions:

Exceptions available to both IRAs (including SEP and SIMPLE IRAs) and Employer-Sponsored Retirement Plans

Death. Funds from an inherited retirement account are always distributed penalty-free. In other words, a distribution taken from an inherited retirement account after the death of the owner is never subject to the 10% penalty. The age of the account owner and or the beneficiary is irrelevant.

Disability. If a distribution is taken from a retirement account, the 10% penalty will not apply if you are disabled. Importantly, such a disability must be present at the time the distribution is taken. Furthermore, to be considered disabled for the purposes of the penalty exception, you must be unable to engage in any gainful activity because of a physical or mental condition. The condition also must be expected to last a long and indefinite period or be expected to result in death. Notably, there are no requirements about how you use the funds. For example, you can pay rent, buy groceries, or even buy a new car. As a reminder, you are still responsible for tax on the pre-tax funds (basis, if any, is distributed tax free) distributed from your retirement account.

This exception to the early distribution penalty only applies to the disability of the account owner. If the spouse or a dependent of the account owner is the one with the disability, the early distribution penalty will apply (unless another exception is satisfied).

Section 72(t) Payments. One such exception is distributions from your retirement account taken under a substantially equal periodic payment (SEPP) program—commonly referred to as a Section 72(t) payment. The payment schedule must run for whichever is longer, five years or until age 59½. Importantly, 72(t) payments are only available from an employer-sponsored retirement plan after separation from service.

To qualify, the payments must be calculated in a specific way, per IRS regulations, and must be taken at least annually. If the payment schedule is modified prior to the account owner reaching age 59 ½ or before five years have elapsed, the 10% penalty will be assessed on all distributions taken prior to age 59½. Failure to take any required amount by the deadline could result in the disqualification of your SEPP.

Medical Expenses. Should your medical expenses exceed 7.5% of your adjusted gross income (AGI) in a year, you may qualify for an exemption from the early withdrawal penalty. This exception allows you to withdraw funds to cover these excess medical costs, regardless of whether you itemize deductions on your tax return. To qualify, the distribution must be made in the same year that the medical expenses were paid.

IRS Tax Levy. Funds paid due to a tax levy by the IRS are not subject to the early distribution penalty. This exception only applies when the retirement account is levied by the IRS. In other words, this exception would not apply if you took an early distribution to pay taxes owed, but there is no levy.

Qualified Reservist Distribution. If you serve in the military reserves, there is an exception to the early distribution penalty. To qualify, a distribution must satisfy the following requirements: you were ordered or called to active duty after September 11, 2001; you were ordered or called to active duty for a period of more than 179 days or for an indefinite period because you are a member of a reserve component; and the distribution was made no earlier than the date of the order or call to active duty and no later than the close of the active duty period.

Qualified Birth or Adoption Distribution. A qualified birth or adoption distribution not to exceed $5,000 is an exception to the early distribution penalty. Notably, you must be the parent of that child in order to qualify, and the distribution must be made during the one-year period beginning on the date on which your child was born or the date on which the legal adoption of your child was finalized. The funds may be repaid at a later date, generally not more than three years (beginning on the day after the date the distribution was received).

Terminal Illness. The early distribution penalty is waived for a terminal illness, upon being certified by a physician as having an illness or physical condition which can reasonably be expected to result in death in 84 months (seven years) or less after the date of the certification. The funds may be repaid at a later date, generally not more than three years (beginning on the day after the date the distribution was received).

Domestic Abuse. The early distribution penalty is waived for victims of domestic abuse. The distribution must be made during the one-year period beginning on any date on which the individual is a victim of domestic abuse by a spouse or domestic partner and up to the lesser of $10,000 (indexed for inflation) or 50% of the account value.

Similar to terminal illness distributions, plans that offer penalty-free distributions to domestic abuse victims must give the individual an opportunity to repay the withdrawn amount over a three-year period.

Federally Declared Disasters. The early distribution penalty is waived due to a federally declared disaster. The distribution is limited to $22,000 (per disaster).

For more information on federally declared disasters see 2024 Publication 590-B. Also, The IRS provides a list of current disaster areas.

Emergency Personal Expenses Distribution. The early distribution penalty is waived for an emergency personal expense distribution taken for the purpose of an unforeseeable or immediate financial need relating to a necessary personal or family emergency expenses. You are limited to taking one emergency personal expense distribution per calendar year, and the amount cannot exceed $1,000. Notably, you may not take another emergency personal expense distribution in subsequent years unless certain requirements are satisfied.

Similar to terminal illness and domestic abuse distributions, plans that offer penalty-free emergency expense distributions must give the individual an opportunity to repay the withdrawn amount over a three-year period.

Exceptions Applicable to IRAs Only (Including SEP and SIMPLE IRAs)

Qualified Higher Education Expenses. Retirement funds can be used to pay higher education expenses, but only when those funds come from an IRA. This exception does not apply to distributions from employer-sponsored retirement plans (i.e., 401(k)).

Qualified higher education expenses include but are not limited to tuition, fees, books, and supplies. Notably, this exception is available to the IRA owner and certain family members, including your spouse; you or your spouse's child, foster child, or adopted child; or you or your spouse's grandchild.

For more information see IRS 2024 Publication 970.

First-Time Homebuyer. Both traditional and Roth IRAs provide an exception to the early distribution penalty by allowing IRA owners to withdraw up to $10,000 (this is a lifetime limit) for a first-time home purchase. (We will spotlight this exception in a future column.)

A first-time homebuyer is someone who has not owned (and if married, whose spouse has not owned) a principal residence during the two-year period ending on the date of acquisition of the principal residence.

Medical Insurance Premiums if You Are Unemployed. You are not subject to the early distribution penalty on distributions during the year that aren't more than the amount you paid during the year for medical insurance for yourself, your spouse, and your dependents. See here for details: 2024 Publication 590-B.

Exceptions Applicable to Employer-Sponsored Plans Only

Age 55. There is an exception to the early distribution penalty when a participant separates from service in the year they attain age 55 or later. Here, the participant qualifies for the exemption in the year of their 55th birthday.

Distributions made to the participant from an employer-sponsored retirement plan (i.e., 401(k)) are exempt from early distribution penalty. Once the funds are rolled over to an IRA, the exemption is lost.

Qualified Public Safety Employees (Age 50 or 25 Years of Service). This exception is similar to the age 55 exception, except with the earlier age of 50 or 25 years of service (with the employer) and only available to certain federal, state, and local public safety employees including specified federal law enforcement officers, corrections officers, customs and border protection officers, federal firefighters, air traffic controllers, and private sector firefighters.

This exemption is permitted for distributions from defined benefit plans, defined contribution plans, or other types of governmental-sponsored retirement plans. Once the funds are rolled over to an IRA, the exemption is lost.

Governmental 457(b) Plans. Distributions from a government-sponsored 457(b) are always penalty free (regardless of the plan participants age) unless the distributed funds represent amounts that were previously rolled over from a 401(k) plan, 403(b) plan or an IRA.

Qualified Domestic Relations Order (QDRO). A QDRO is used to split funds from an employer-sponsored retirement plan in a divorce. A distribution by reason of QDRO allows the ex-spouse to receive penalty-free distributions while funds are held in a qualified retirement plan (i.e., 401(k)). In other words, distributions from the employer plan to the ex-spouse are not subject to the early distribution penalty. Once the funds are rolled over to an IRA, the exemption is lost.

Pension-Linked Emergency Savings Accounts (PLESA). PLESAs deviate from the traditional rules of when retirement funds can be accessed and distributed, by offering plan participants the option to withdraw all, or a portion, of their PLESA funds monthly. Furthermore, participant contributions to a PLESA are required to be made on a Roth basis, and pre-age 59½ distributions would not be subject to the 10% early distribution penalty.

Additional exceptions from the 10% early distribution penalty include Roth conversions, returned IRA contributions and rollovers to an IRA or another eligible retirement plan within 60 days.

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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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