

Understanding the 10% penalty on early distributions

Congress intended investments with certain tax advantages, such as annuities, IRAs and other qualified retirement plans, to be used primarily as long-term investments rather than short-term tax shelters. Congress wanted to encourage saving both for and during retirement. Therefore, Congress enacted rules that discourage early distributions or withdrawals from these investments. One of these rules is the 10% penalty tax on distributions made prior to age 59½.

While there may be reasons you'd want to consider a withdrawal prior to age 59½, it's important to work with your financial and tax professionals to understand any implications of doing so. While the penalty applies in most scenarios, there are a number of very precise and limited exceptions that vary by plan type.

Exceptions to the 10% early distribution penalty

	Nonqualified annuity	Qualified 401(a), 401(k) and 403(b) plans	Traditional IRAs, Roth IRAs, SEP IRA and Simple IRA
Death	✓	✓	✓
Disability	✓	✓	✓
Substantially equal periodic payments	✓	✓	✓
Immediate annuity	✓		
Qualified funding asset	✓		
Separation from service after age 55		✓	
Distributions to reduce excess contributions		✓	
Qualified domestic relations order		✓	
Certain medical expenses		✓	✓
Higher education expenses			✓
Health insurance premiums while unemployed			✓
Qualified first-time homebuyer			✓
Birth or adoption expenses			✓

Let's define

Death - Distributions made to a beneficiary.

Disability - Distributions made because the owner is disabled, defined as the inability to engage in any substantially gainful activity because of a physical or mental impairment expected to result in death or for an indefinite period per IRC Section 72(m)(7).

Substantially Equal Periodic Payments - Distributions made when the individual opts to receive a series of substantially equal period payments based on life expectancy. See more on this below.

Immediate Annuity - A single premium immediate annuity can provide a guaranteed fixed income stream that is not subject to the 10% penalty.

Qualified Funding Asset - An annuity issued by a licensed insurance company purchased by a party who has an obligation to another individual, usually because of a judgment, settlement or damages.

Separation from Employment (Age 55+) - Distributions made from an employer-sponsored plan from which an individual separated during or after the year they turn age 55.

Reduce Excess Contributions - Distributions made to correct excess distributions or deferrals to a qualified retirement plan.

QDRO - Distributions made under a judgment, decree or order according to state domestic relations law for child support, alimony or marital property rights.

Medical Expenses - Distributions made to pay qualifying medical expenses (as defined by IRC Section 213), only if those expenses exceed 7.5% of the taxpayer's adjusted gross income (AGI).

Higher Education - Distributions made for tuition, fees, books, supplies, and equipment required for attendance of the taxpayer, their spouse, their child, or their grandchild at an eligible educational institution.

Health Insurance Premiums - Distributions made to pay health insurance premiums for an individual who received unemployment benefits for at least 12 weeks.

First-time Homebuyer - Distributions made to purchase a home for an individual who has not owned a home in the previous 24 months with a lifetime maximum of \$10,000.

Birth or Adoption Expenses - Distributions made within 12 months of a qualified birth or adoption up to \$5,000 per person.



Let's take a closer look at substantially equal period payments (SEPP)

No penalty applies to distributions made when an individual opts to receive a series of substantially equal period payments over their life expectancy.

- The payments must be made for the longer of five years or when the individual reaches 59½ so it is often not ideal for a short-term financial need.
 - Example: Jim is 40 years old. He begins a SEPP program. Jim is required to continue the SEPP program until he is 59½, which is 19½ years from now.
 - Example: Mia is 56 years old. She begins a SEPP program. Mia must take the distributions for at least 5 years until she is 61.

How to

You'll need to use one of the following methods to calculate your SEPP program and work with a tax advisor to ensure accuracy and conformity:

1. Required Minimum Distribution – Dividing the account balance by the number from a life expectancy table that is re-determined each year. This usually results in the lowest distribution amount.
2. Fixed Amortization – Taking an equal amount each year based on the account balance, a chosen life expectancy table, and a chosen reasonable interest rate. This usually results in the highest distribution amount.
3. Fixed Annuitization – Dividing the account balance by an annuity factor that is the present value of an annuity of \$1 per year beginning at the owner's age and continuing for the life of the owner using the mortality table.

Age: Use the age of the owner on his or her birthday in the given year.

Account Balance: Use a reasonable method, such as the date of the first distribution or the previous end of year balance.

Life Expectancy: Uniform lifetime, Single life expectancy, or Joint and Last survivor tables.

Reasonable Interest Rate: Any rate less than 120% of the Federal Mid-Term rate for either of the two months preceding the month when distribution begins.



Important considerations

If you fail to take the payments or modify payments, including taking another distribution, it will trigger the 10% penalty and interest from prior distributions. *There is a one-time exception to the modification if the owner started a SEPP program under a fixed amortization or fixed annuitization schedule and does a onetime change to the required minimum distribution schedule.*

An annuity is intended to be a long-term, tax-deferred retirement vehicle. Earnings are taxable as ordinary income when distributed, and if withdrawn before age 59½, may be subject to a 10% federal tax penalty. If the annuity will fund an IRA or other tax qualified plan, the tax deferral feature offers no additional value. Qualified distributions from a Roth IRA are generally excluded from gross income, but taxes and penalties may apply to nonqualified distributions. Please consult a tax advisor for specific information. There are charges and expenses associated with annuities, such as surrender charges (deferred sales charges) for early withdrawals. Variable annuities have additional expenses such as mortality and expense risk, administrative charge, investment management fees and rider fees. Variable sub accounts of annuities are subject to market fluctuation, investment risk and loss of principal.

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