When You Need Your Money Now: Early Distribution

In several situations there may be an early distribution from your plan. This is good because you do not have to wait; but it can come with a heavy cost. As you know, when you receive a distribution you must report that money as income and pay taxes on it. But if you take a distribution before the age 59 1N2 you may also have to pay an additional 10 percent early withdrawal federal income tax penalty, which can seriously reduce your retirement funds. The key is to know how to avoid this extra tax.

The government provides several possible ways for you to sidestep the 10 percent early withdrawal federal income tax penalty when you retire. However, the IRS has strict rules, so dot your i's and cross your t's.

Age 55 Early Retirement

The concept of an early retirement is seductive. Who wouldn't want to retire in their early 50s and enjoy the good life? The government recognizes this attraction and offers you a compromise- simply stay at your current employer until the year you turn 55, then retire. Notice that you don't have to be exactly 55. You can retire on January 1 of the calendar year in which you will eventually become 55. Also, you don't have to stay retired. You can go to work again, even for the same employer. But to receive the age 55 distribution, you must at some point terminate your employment and retire.

If you are thinking of retiring at age 53 and keeping the money in your plan two more years, think again. Just keeping your money in the plan until age 55 will not prevent an early distribution tax. You must actually continue employment until the year you turn 55.

Periodic Payments

Both the IRS and some plans permit you to take regular payments from your account over time. These payments will be taxed as ordinary income but will not receive the 10 percent early withdrawal federal income tax penalty, regardless of your age.

However, there are two requirements. First, you must have terminated employment before payments begin. Second, you must conform to the IRS required format and computation method for determining payments. The IRS only provides for "substantially equal" fixed payments, based on the life expectancy of you and your spouse.

Medical Expenses

If you have deductible medical expenses, then you avoid the 10 percent penalty for the amount of your distribution that does not exceed your deductible medical expenses for the year. The penalty does not apply even if you do not actually deduct the medical expenses.

Qualified Domestic Relations Order (QDRO) Payments

Your plan can be forced to distribute your plan assets to pay child support, alimony, or a settlement to a former spouse, child or dependent as required by a QDRO. The distribution will be taxable income for the person receiving the payment but the additional 10 percent early withdrawal penalty will not apply.

However, a valid QDRO that clearly defines how the account is to be shared must be in place, not just an informal agreement. If you are planning to get a divorce, make sure your attorney contacts the plan administrator before the divorce is final to determine the plan's requirements for a QDRO. Many plans have sample QDROs that will assist your divorce attorney with this process.

Disability

If you become permanently disabled, then you can withdraw money from your plan. Such distributions are taxed as income but are free from the 10 percent early withdrawal federal income tax penalty. However, the IRS is particular about who they deem disabled. In order to be considered disabled, the law requires that you be unable to engage in any substantial gainful activity. You must be able to prove both the existence and the permanence of the disability, with an emphasis on how this condition is unchangeable, to be allowed access to your funds.

Death

If you die, your beneficiary will receive the money in your 401(k) account. If you do not designate a beneficiary, the money will automatically go to your estate (if you are not married) or to your spouse (if you are married). However, the money will go to your spouse regardless of who you designate as your beneficiary unless your spouse has agreed in advance to an alternate agreement. Your spouse will be required to pay regular income taxes on these funds, but the 10 percent early withdrawal federal tax penalty will not apply. Spouses may also roll the money over tax-free into their own IRA or employer provided plan, deferring taxes until they withdraw the money. Please note that if your account balance is more than $5,000, your spouse (but not other beneficiaries) may keep the money in the plan until the date you would have reached age 70 1N2.

Nonspouse beneficiaries may roll the money over tax-free into an IRA in the name of the decedent that will then be treated the same as an inherited IRA. The nonspouse beneficiary would avoid receiving the entire 401(k) account as income in the year of distribution and the 10 percent early withdrawal federal tax penalty will not apply. IRA distribution rules would then apply to the inherited IRA.