Everything You Always Wanted to Ask About The 10% Early Withdrawal Penalty (EWP) and IRAs, Employer Retirement Plans and Annuities But Were Afraid to Ask

Exceptions to the 10% Early Withdrawal Penalty

4D IRS Child's MEAL at home before 59 1/2

D – Death
D – Disability
D – Divorce/marital separation
D – Disaster (Qualified Disaster Distributions up to $100,000)

I – Insurance for health care when unemployed
R – Reservist/qualified reservist
S – Substantially equal periodic payments or Section 72(t)

Child's – The birth or adoption of a child under 18

M – Medical expenses over 7.5% of AGI
E – Education expenses for higher education
A – Annuitized distributions
L – Levy by the IRS
S – Separation from service at 55

Home – Qualified first-time homeowner expenses up to $10,000 lifetime maximum

59½ – Distributions after 59½

Starting in 2020, up to $5,000/parent/event can be withdrawn from an employer retirement plan or IRA for a year after the birth or adoption of a child under 18 as an exception to the 10% EWP. Of course the withdrawal is subject to income tax, but not the 10% EWP. This withdrawal must not be before the birth or the adoption is finalized and the withdrawal period ends one year after the event. If the person being adopted is disabled, there is no age restriction. Finally, the withdrawal may be paid back to the employer retirement plan or IRA.

<u>Employer Retirement Plan Exceptions to the 10% Early Withdrawal Penalty</u>

1. Employer retirement plans have many of the same exceptions as IRAs. However, employer retirement plans <u>do not have the exceptions for</u>:

   a. Qualified higher education costs
   b. $10,000 of first-time homeowner costs
   c. Certain health insurance premiums while unemployed.

      - You lost your job.
      - You received unemployment compensation for 12 consecutive weeks because you lost your job.
      - You receive the distribution in the year you received the unemployment compensation or the following year

- You received the distributions not later than 60 days after you were reemployed.

Thus, if there is a choice of funding these three issues from an IRA or from an employer retirement plan when the client is younger than 59 ½, then taking the withdrawal from an IRA is better. Both sources would be subject to income tax, but at least the client is spared the 10% EWP.

2. Employer plans have some unique exceptions to the 10% EWP that IRAs do not:

a. Separation from service in the year you turn 55 or later. That is why the early retirement age for employer retirement plans like 401(k), etc. is 55. The employer plans would never say, "We are okay to never see you again as early as 55 and we don't care that you would have to pay the 10% EWP." They set the age at 55 for employer plans because there is no 10% EWP if you separate from service in the year you will be 55 or later. Of course you have to separate from service or this exception would not apply.

b. Distributions under a QDRO (Qualified Domestic Relations Order). Like an IRA, there is no 10% EWP for separating money from the employer retirement account under orders from a court in a divorce situation. However, if money is withdrawn later from the ex-spouse's new retirement account under a QDRO, then there is no 10% penalty. For example, Terry and Sarah divorced. Terry had a 401(k) worth $200,000 and an IRA worth $50,000. The divorce decree gave Sarah half of each account. Terry and Sarah are each 50 years old.

- When the two accounts were split in half after the divorce was finalized, there was no 10% EWP or for either Terry or Sarah. Now Terry is totally off the hook for any withdrawals from either of Sarah's new retirement accounts.

- Sarah received $100,000 of the 401(k) under a QDRO and withdrew $50,000 for various living expenses. She is income taxed on the $50,000 withdrawal, but she is not penalized 10% because the withdrawal was under a QDRO.

- Sarah also immediately withdrew all $25,000 from her new IRA account. This was not under a QDRO, so she is both income taxed and also subject to the 10% EWP on the entire $25,000.

- Takeaway from the story, employer retirement accounts should be received in a divorce instead of IRA assets if the receiver is less than 59 ½. Sarah would have been better off with $125,000 of the 401(k) and none of the IRA.

c. ESOP (Employer Stock Ownership) distributions

<u>What about Non-Qualified Annuities</u>?

A non-qualified annuity is simply and annuity product in which the investor does not get an income tax deduction when contributing to the annuity (fixed or variable annuities). Then the money grows inside the annuity tax deferred until withdrawal. Upon withdrawal the earnings are income taxed. The earnings are also subject to a 10% early withdrawal penalty unless the withdrawal meets an exception to the 10% early withdrawal. Any principal withdrawn is not subject to income tax or the 10% EWP under any circumstance.

These annuities only have an exception to the 10% early withdrawal penalty for the following reasons:

1. The owner is 59 ½ or older when he or she withdrew the money.
2. The owner is disabled when the money is withdrawn.
3. The owner has died and the beneficiary has become the new owner of the annuity.
    a. No beneficiary will ever be subject to the 10% early withdrawal penalty because the annuity was received due to an original owner's death.
    b. Immediate income tax implications for the beneficiary. The beneficiary will immediately be income taxed on the earnings as of the date of death for the original owner. This is true whether or not the beneficiary withdraws the money. If the beneficiary leaves the money in the annuity, the beneficiary's new basis is the date of death value but <u>NOT</u> because the beneficiary received a stepped-up basis. This is not a stepped-up basis because the <u>beneficiary paid income taxes on the earnings from the deceased's contributions</u>. For example, Grandma invested $50,000 in an annuity. It was worth $60,000 when Grandma died. Daughter was the beneficiary of the annuity. Daughter is income taxed on the $10,000 of earnings immediately (even she left the money inside the annuity). Now Daughter's basis is $60,000.

Bonus Info on the Income Tax Treatment of a Non-Qualified Annuity Withdrawal

Withdrawals from annuities are income taxed under different rules depending on the type of withdrawal. For income tax purposes, there are only two types of withdrawals: annuitized withdrawals and non-annuitized withdrawals.

1. If the owner annuitizes the money, each payment is prorated between earnings and principal. The formula for this proration is:

$$\frac{\text{After-Tax Contribution}}{\text{Expected Return}} = \text{The Tax Free Principal Portion of the Payments}$$

    The expected return is the monthly payments times the life expectancy in months. For example, if the life expectancy when the owner annuitized is 20 years and the annuity payment is $1,000/month, then the expected return is $240,000. If the owner contributed $180,000, then 75% of each annuity payment is income tax free until the owner has recovered all $180,000 income tax free. Then the entire annuity payment becomes taxable income.

    A test can ask how much of the annuity payment will be tax-free or how much of the annuity payment will be taxable income. The calculation above used the "exclusion ratio" to calculate the $750/month that was a tax-free return of principal. However, that left $250/month or $3,000/year as taxable income.

A second way to calculate the exclusion ratio is to <u>divide the **after-tax** contribution by the number of payments a person is expected to receive</u> as found on an IRS chart that lists the number of payments expected according to the age at which the owner annuitized the annuity.

2. If the owner does not annuitize, then the payment(s) is taxed under a type of LIFO (Last In First Out, but technically "earnings first"). For example, Joe invested $100,000 in an annuity. When he was 50 years old it was worth $110,000. He withdrew $15,000 to buy a boat. His is in the 22% marginal tax bracket. How much does he owe the IRS for this withdrawal?

   a. LIFO/earnings first says $10,000 is subject to income tax. He is not dead, disabled or annuitized so he owes the 10% EWP on the $10,000 as well. Thus the income tax bill for the first $10,000 withdrawn would be $3,200. $2,200 of income tax and $1,000 of 10% EWP.

   b. The remaining $5,000 is a return of principal so it is not income taxed, nor is it 10% penalized.