Living in Retirement

Tax Issues and Distributions From Qualified Accounts

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By Brad Pistole

Do you find the tax code confusing? Most individuals have a difficult time identifying the differences between an IRA, 401(k), 403(b), TSP, 457, and a Roth IRA account. Each of these accounts have specific rules for contributions and distributions. And these rules get even more complicated depending on your age. There are specific rules if you are under the age of 50 and 59½ and specific rules if you are above the age of 70½. These accounts require knowledge about many topics and the rules can be very confusing. Individuals who study these accounts on a daily basis struggle with keeping it all straight, and it seems the rules are always changing.

Perhaps one of the most confusing rules regarding taking distributions from qualified accounts involves the magic number 59½. As you may know, you cannot take a distribution from a qualified account before the age of 59½ (with a few exceptions) or you will incur a 10% penalty from Uncle Sam. Why did Uncle Sam choose age 59½ instead of 59 or 60?

I would love to ask him that and a host of other questions, but the answer is: "It is what it is and we must abide by it."

Most of us were told to contribute to our 401(k)s in the very first few days of entering the work force. It certainly seems like a great idea! You get to take a tax deduction now, lowering your taxable income, and in most cases, you will even receive a match or free money from your employer up to a certain amount. Who wouldn't want to do that?

One of the problems with contributing to a 401(k) or any other tax-deferred account doesn't ever come up until you need the money. If you experience a life event such as a change in jobs, divorce, financial hardship, or the decision to retire early, chances are you never thought about what happens if you take distributions from these accounts before Uncle Sam's magic age of 59½.

Distributions from qualified accounts before the age of 59 ½ pose many problems. Two of the biggest problems include taxes and penalties. Remember, when you take a distribution from a tax-deferred account, it will be taxed as ordinary income. If you take the distribution before age 59½ (with few exceptions), it will be taxed and penalized 10%.

However, if you find yourself in a situation where you need to take a distribution from a qualified account before the age of 59½ and you don't meet one of the qualifications for avoiding the 10% penalty, there may be a way for you to do this. It's called a 72(t) distribution. A 72(t) distribution is also known as a "substantially equal periodic payment plan." When there is an immediate need for income and you want to avoid the 10% penalty for taking the distribution before age 59½, you can always execute the 72(t) move. But be warned, the rules that govern the 72(t) distribution are like many other IRS regulations: they can be confusing and they must be followed exactly or taxes and penalties will apply. That's why you should always work with someone who specializes in qualified accounts and distributions.

Let's examine some of the main things to keep in mind if you are considering using a 72(t) distribution to avoid the 10% penalty for accessing your qualified account before the age of 59 ½.

A 72(t) distribution is a substantially equal periodic payment and it cannot be changed once it has been set in place. You might need to read that statement again. There are very few exceptions to a 72(t) payment plan once it starts. Things like the death of the owner or disability will alter the plan, but outside of this, you need to make sure you are able to stick with the plan and follow the distribution rules to avoid penalties. If you can, the 72(t) might be exactly what you're looking for.

You cannot start a 72(t) payment plan from an employer plan until you leave the company. You can start a 72(t) payment plan from an IRA at any age, however, once you start this plan the distributions must continue for five years or until the age of 59½, whichever is longest. This is the first and most important thing to considering before starting your 72(t) distribution, so let's use a couple of examples.

Sam, age 52, after working for his company for 30 years, decides to retire early. He has built up the majority of his retirement savings in a 401(k). Once he retires, he rolls over his 401(k) to an IRA so he can control the account and access the funds. Since he is under the age of 59½, he quickly realizes any distribution from the IRA will be taxable and will incur the 10% penalty. He decides to set up a 72(t) distribution plan. At what age will Sam be able to stop the 72(t) distributions? Before you answer age 57 (satisfying the five-year rule), remember the distribution rules state you must take distributions for "five years or until the age of 59 ½, whichever is longest." Sam will have to take equal payments from age 52 until the age of 59 ½ because it is the later of the two. This is a commitment he must be willing to make, no matter what might change in his life, in order to avoid the penalties involved.

Jan, age 57, retired from her job when she was 54. After a few years of retired life, she ran into some financial issues and decided she would have to go back to work. After considering all of her options, she realized her 401(k) was the only account she had that would provide the income she needed until she finds another job. Jan decides to set up a 72(t) payment plan, using her 401(k). At what age will Jan be able to stop the 72 (t) payments? Remember the ordering rules, "you must take distributions for five years or until the age of 59½, whichever is longest." In this case, Jan must continue taking equally substantial payments from her 401k for 5 full years. Even though she will be 63 before the 5 years is over, she must complete the full five years of payments. What if Jan lands a wonderful new job and no longer needs the income from the 72(t) plan? In order to avoid penalties, Jan must continue the taxable distributions from the plan until five full years have passed.

Using a 72(t) plan might be right for your specific situation. It provides a way for you to avoid the 10% penalty on distributions before the age of 59 ½ and can provide you with the income you need when the situation arises. However, this involves a firm commitment and you must work with someone who is experienced in setting up the 72(t) payment plan. If you fail to satisfy any of the rules of the 72(t), the tax consequences are serious. The 10% early distribution penalty will apply retroactively to all the 72(t) payments you have taken.

There are some other exceptions to the pre-59½ 10% penalty distribution rule. If you have a company plan and you separate from service at age 55 or later, you can take distributions from the company plan and avoid the 10% early penalty. Keep in mind, this can only be done if you take the distributions from the company plan. If you roll your funds over from the company plan to an IRA, there are different rules involved and you would lose the special exception allowing you to avoid the 10% penalty for early distributions.

If you are a federal, state or public safety employee, such as a policeman, emergency medical person, or fire fighter, you can avoid the 10% penalty associated with taking distributions from your retirement plan, as long as you separate from service any time after the age of 50.

There are many other factors, rules and exceptions that can come into play when deciding to use a 72(t) plan. Always consult your financial professional and ask plenty of questions before making a decision to take any distribution from a qualified account.

Don't ever forget what IRA stands for: Individual Retirement Arrangement. Read more in IRS Publication 590.

When you start any tax-deferred retirement savings account, you have entered into an agreement with Uncle Sam and there are always rules to follow. And trust me, he expects them to be followed.

About the author: Brad Pistole is the CEO of Trinity Insurance & Financial Services. Pistole is a member of the Ed Slott Master Elite IRA Advisor Group, an MDRT Top of the Table Advisor, and the author of Safe Money Matters - Finding Safe Harbor in a Storm-Filled World. He was the 2018 Safe Money Radio National Advisor of the Year.
