Tax Law is Complex for Those Dipping Into Retirement Savings

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Many Americans have been faithfully contributing to their retirement plans for years in hopes of saving enough for their retirement. However, over the past few years many people have been hit with unexpected financial hardship and are now looking to liquidate their retirement nest egg. Retirement plan distributions represent some of the most complex areas of tax law and pre-retirement distributions are especially encumbered with IRS tax traps. The reason for such complexity is the fact that the IRS treats distributions differently based upon the type of distribution, the type of retirement plan, the circumstances surrounding the distribution and the age of the plan participant.

One potential drawback to early distributions is the 10 percent premature distribution penalty. This penalty is assessed when a taxpayer under the age of 59½ takes a distribution from most types of retirement accounts. Fortunately, there are some important exceptions available depending on the plan type. Exceptions to the 10 percent rule can differ between qualified plans, such as 401(k) plans, and other retirement accounts such as IRAs. Some of the common exceptions to the 10 percent penalty include:

- Permanent disability.

- Medical expenses exceeding certain adjusted gross income limits.

- Distributions that are part of substantially equal periodic payments made over the participant's life expectancy.

- Funds used by a first-time home-buyer (up to $10,000).

- Funds used to pay for qualified educational expenses.

Another area of concern is the fact that most distributions will generally be subject to ordinary income tax rates instead of preferential capital gains rates. If contributions to plans have been made on a pre-tax basis, most distributions will be subject to normal income taxation. Thus the expected pre-retirement distribution amount can be significantly reduced due to the combination of the 10 percent early withdrawal penalty and ordinary income taxation. For example, suppose a relatively young employee is terminated from work and offered a lump-sum distribution from his/her company plan in an amount equal to $150,000. Assuming an effective tax rate of 25 percent, the employee would receive only $97,500 of the entire $150,000. The erosion of the distribution results from ordinary income taxation and the 10 percent premature distribution penalty. Other factors, such as state taxation and investment losses, may further diminish the net distribution available to the participant.

Other complications may arise because company plans often have specific rules relating to pre-retirement distributions and hardship withdrawals. Some employer plans may not allow employees to participate in the plan for a certain period of time after a hardship withdrawal has been elected. Pre-retirement distributions require special attention and proper tax planning strategies can be implemented to mitigate excessive taxation on early distributions. Those considering early distributions should consult with their plan administrator and tax adviser before proceeding.

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