Premature distributions: what you should know

Wealth Management

In the future, you will depend on the assets you've accumulated in your retirement plans and IRA(s) to provide you with income during your retirement years. However, you may have urgent financial needs right now—and you might be thinking about withdrawing money from one of these accounts to help pay bills you have today.

The government wants to encourage you to use these accounts for their intended purpose: funding your retirement. So, if you are younger than age 59½ there are important rules you should know before you take what the IRS calls a "premature distribution" from your retirement account.

Taxes — One of the advantages of funding your traditional IRA, 401(k), 403(b) or other tax-deferred retirement account is that your contribution can lower your taxable income. Withdrawals, on the other hand, are generally taxable. When you take money out, you will need to pay income taxes on the amount of the distribution, regardless of the age at which you take it. (Note: Roth accounts are funded with after-tax dollars and, as a result, qualifying distributions from Roth accounts are not taxed.)

> Example: Let's say you decide you need to take $10,000 out of a tax-deferred retirement account. If you are in the 25% federal tax bracket and your state charges 5% tax, you will pay $3,000 in taxes, leaving you with $7,000.

Penalties — If you are younger than age 59½, in addition to paying taxes on the distribution, the IRS may charge you a 10% penalty on the amount you are withdrawing from your retirement account.

> Example: Of the $10,000 distribution in the example, you may need to pay a 10% penalty which will further reduce the amount you receive by $1,000. After taxes and penalties, you wind up with only $6,000—nearly half of the original $10,000.

Lost future income potential — Not only do you run the risk of losing a significant portion of your hard-earned retirement savings to taxes and penalties, if you take a premature distribution those assets will not be able to grow, and they will not be available to you when you need them during retirement.

> Example: Let's say you left the $10,000 in your retirement account and it earned a 6% rate of return every year for 20 years. Without putting any more money into the account, the $10,000 would grow to $32,071—more than triple the original $10,000.

Exceptions to the rules — Many people consider taking a premature distribution to solve problems caused by an unexpected financial hardship. Good news: the government understands there may be times when people have a legitimate financial need. Provisions of Section 72(t) of the Internal Revenue Code provide a number of exceptions under which no penalty will be assessed. (Ordinary income taxes still apply, however.)

Exceptions available to all retirement plans and IRAs*

- Qualified transfer or roll over to another retirement plan
- Distributions made to your beneficiary after your death

- Unreimbursed medical expenses that are greater than 10% of your adjusted gross income (AGI) for 2021 (greater than 7.5% of AGI for 2017–2020)
- Distributions made because of a qualifying disability
- Qualified reservist distributions
- Substantially equal periodic payments
- Involuntary distributions due to IRS levy on the account
- Qualified birth or adoption distributions (QBOAD)
- Survivors of domestic abuse (limited to $10,000, effective 2024)
- Emergency withdrawal exception (limited to $1,000)
- Principal place of residence in qualified disaster area (up to $22,000)
- Qualified long-term care premium payments (limited to $2,500 annually)
- Terminally ill

Exceptions available only to IRAs

- Qualified post-secondary education expenses for you, your spouse, your child or grandchild
- First time homebuyer expenses for primary residence, up to $10,000 lifetime limit
- Health insurance premiums during period of qualified unemployment

Exceptions available only to qualified plans (e.g., 401(k), 403(b), ESOP, profit sharing)

- Distributions to an alternate person authorized by a qualified domestic relations order (QDRO)
- Distributions made to participants after they separate from service, if the separation occurred in or after the year they reached age 55, or distributions made from a qualified governmental benefit plan, where they separated from service in or after the year they reached age 50.
- Distributions of dividends from an employer's employee stock option plan (ESOP)

What about pre-mature distributions from other retirement accounts?

Distributions from governmental 457(b) plans are not subject to the early distribution penalty, unless the distribution represents amounts that were rolled over from another tax-deferred plan. Distributions from Roth accounts are not subject to the early distribution penalty, unless the distribution is nonqualified and is taken from account earnings or from conversions that have been in the Roth less than five years.

Next steps

Now that you know some of the consequences of taking a premature distribution and some of the exceptions that may be available, is withdrawing funds from your retirement account the best possible solution for your current and future financial needs?

Talk with your RBC Wealth Management financial advisor and your tax advisor before you do anything you may regret later. Because as experienced financial professionals, they may be able to offer suggestions to help you satisfy your immediate income needs requirements, while not putting your retirement savings in jeopardy.

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