Avoiding the 10% Penalty in *5 Easy Steps*

What is the 10% penalty?

A 10% early distribution penalty applies to taxable distributions made before age 59 ½. Distributions made after age 59 ½ are not subject to the 10% early distribution penalty.

Exceptions: Age 55 for employer plans when you separate from service in the year you turn 55 or later; age 50 for public safety employees in governmental defined benefit plans who separate from service; for SIMPLE IRAs, the penalty is 25% for the first two years in the plan, then reverts back to the 10% penalty in following years.

#1 **Check the age of the IRA owner, look for an exception to the penalty.** The main exceptions are disability, death (distributions to beneficiaries are never subject to the penalty), medical expenses generally in excess of 7.5% to 10% of AGI (adjusted gross income) in the year of distribution, first-time homebuyers, higher education expenses, and health insurance for the unemployed receiving unemployment compensation for 12 consecutive weeks.

#2 **If no other exceptions are available, pick one of the IRS approved methods under Code Sec. 72(t).** The three methods are: annuitization, amortization and the required minimum distribution method (RMD). The interest rate used for amortization and annuitization methods cannot exceed 120% of the federal midterm rate in either of the 2 months preceeding the first distribution. There are Internet calculators to help with these calculations.

#3 **72(t) payment modifications.** Once a 72(t) payment plan is established, it cannot be modified during the payment period except in the case of death, disability or a one-time (penalty-free) change from the annuity or amortization method to the RMD method. If a modification does not fit into any of these categories, the 10% penalty is applied retroactively to all distributions taken before age 59 ½, plus interest.

#4 **Take advantage of change.** An IRA owner who initially needs larger 72(t) payments can use the fixed amortization or annuity method and then switch to the RMD method when larger distributions are no longer needed.

#5 **Stay on top of annual distributions.** Follow up with the plan provider to ensure that distributions are coded correctly. If using the 72(t) exemption, keep track of annual distributions and the number of years left.

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