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Early Withdrawals from Individual Retirement Accounts (IRAs) and 401(k) Plans

Background

Congress created incentives for certain individuals to save for retirement through Individual Retirement Accounts (IRAs) and 401(k)s. Employees (and sometimes employers in the case of 401(k) plans) contribute funds to a tax-advantaged account, which can then be used as an income source in retirement. To discourage account owners from withdrawing funds before retirement, the Internal Revenue Code (IRC) generally imposes a 10% penalty (in addition to applicable income taxes) on *early withdrawals*, which are withdrawals that occur before an individual reaches age 59½.

Individuals who make early withdrawals are subject to rules that vary by plan type, the circumstance warranting a withdrawal, and plan-specific rules. IRAs generally have fewer restrictions on early withdrawals than do 401(k)s. For example, individuals may withdraw funds, but generally with a penalty, from an IRA for any reason, but withdrawals from 401(k)s (1) must be allowed by the plan and (2) may be an *in-service distribution* (i.e., a distribution while an employee is still working) or a *hardship distribution* (i.e., for an employee's hardship reason).

Individual Retirement Accounts

IRAs are tax-advantaged savings accounts for individuals or married couples. IRAs are funded by three sources: the individual's contributions, rollovers (i.e., transfers), and earnings. Traditional IRA contributions can be tax deductible, but withdrawals are generally included in taxable income. Roth IRA contributions are not tax deductible, but qualified distributions (defined below) are not included in taxable income. Both types allow account owners to withdraw funds at any time, but they have distinct rules governing early withdrawals.

Early Withdrawals from Traditional IRAs

Early withdrawals from traditional IRAs—those occurring before age 59½—are subject to a 10% penalty unless an exception described below applies. The withdrawal amount is also included in taxable income.

Early Withdrawals from Roth IRAs

Roth IRA distributions (i.e., withdrawals) are characterized as (1) returns of regular contributions, (2) qualified distributions, and (3) nonqualified distributions. Each is subject to distinct withdrawal rules.

Returns of regular contributions, which are withdrawals of original contributions, are neither included in taxable income nor subject to the 10% penalty.

Qualified distributions, which include earnings on contributions, are those that occur after the account is at least five years old and are (1) made after an account owner turns 59½, (2) made after an account owner becomes disabled, (3) made to a beneficiary after an account owner's death, or (4) used for a first-time home purchase. Qualified distributions are not subject to income tax or the 10% penalty.

Nonqualified distributions are those that do not meet the qualified distribution guidelines and are subject to a 10% penalty unless an exception applies. The taxable portion of any nonqualified distribution (e.g., earnings on contributions) may be included in taxable income. Conversions—rollovers from a traditional IRA to a Roth IRA—that have not met a separate five-year requirement are considered nonqualified distributions and are subject to the penalty. Conversions and rollovers from other Roth IRAs are not included in taxable income.

401(k) Plans

A 401(k) is an employer-sponsored retirement savings plan in which participants have individual accounts. Employee contributions are excluded from taxable income (up to a contribution limit), but withdrawals are included in taxable income. Some 401(k) plans include an employer match, in which employers contribute to an employee's account based on the employee's contribution levels.

Plans are required to distribute vested benefits—those that are owed to an employee based on plan rules—upon certain distributable events, such as an employee's death, disability, retirement, or separation from service. Retirement age varies by plan but typically ranges from age 62 to age 65. Employees may also receive distributions upon a plan's termination.

Employees under 55 years of age who separate from an employer and take a distribution instead of keeping the balance in the plan or rolling it over to a new employer plan or an IRA face a 10% penalty.

Plans may allow (1) in-service distributions and (2) hardship distributions. In both cases, if the account owner has not reached age 59½, distributions are included in taxable income and are subject to a 10% penalty unless an exception described below applies. Plan documents specify whether these features are available and, in the case of a hardship distribution, the requirements to demonstrate one.

In addition, plans may allow participants to borrow (i.e., in the form of loans) from their accounts. Loans are not early withdrawals except in the case of default. If default occurs,

the outstanding balance is included in taxable income and subject to a 10% penalty if the account owner is younger than age 59½.

In-Service Distributions

If plans allow employees who are currently working for the employer sponsoring the plan to take in-service distributions, employees generally must satisfy an age requirement (typically 59½ or older) and a length-of-employment requirement.

Hardship Distributions

Plans may allow distributions for employees who face an *immediate and heavy financial need*. Amounts withdrawn must satisfy the financial need and may include amounts necessary to pay taxes or penalties on the distribution. Hardship distributions are not considered necessary if an employee has other resources to meet the need.

Plans vary in defining which situations qualify for a hardship distribution. Regulations automatically deem certain expenses to be made on account of immediate and heavy financial need (26 C.F.R §1.401[k]-1[d][3][B]). These expenses include, among others, first-home purchase costs (excluding mortgage payments), certain postsecondary tuition expenses, certain medical expenses, payments to prevent eviction or foreclosure, and expenses related to damages from a federally-declared disaster. Hardship distributions to employees younger than age 59½ are not exempt from the 10% penalty unless an exception applies.

Recent Legislative Changes to Hardship Distributions

Prior to 2019, participants were unable to (1) make contributions for a six-month period following a hardship distribution or (2) take a hardship distribution before requesting a plan loan. Sections 41113 and 41114 of the Bipartisan Budget Act of 2018 (P.L. 115-123) eliminated these requirements. P.L. 115-123 also expanded the types of contributions and earnings that can be received as hardship distributions to include employee contributions, qualified nonelective and matching contributions, and related earnings.

Exceptions to the 10% Penalty

Exceptions to the 10% penalty for certain expenses are in 26 U.S.C. 72(t). Some of these exceptions apply to both types of plans, whereas others apply only to qualified employer plans, such as 401(k)s, or to IRAs.

Exceptions for IRAs and 401(k) Plans

Exempt from the penalty are withdrawals that occur after an account owner reaches age 59½, dies, or becomes disabled. Also exempt are *substantially equal periodic payments* (i.e., regular distributions for individuals under age 59½ that are based on IRS formulas), withdrawals to pay an IRS levy, and withdrawals for unreimbursed medical expenses in excess of 7.5% of adjusted gross income) (10% if under age 65). Other exemptions include rollovers and certain distributions for qualified military reservists.

Exceptions for IRAs Only

Exempt from the penalty are IRA withdrawals used to pay health insurance premiums while unemployed, withdrawals of up to $10,000 for first-time homebuyers, and withdrawals used to pay qualified higher education expenses. Returned IRA contributions—contributions made and then withdrawn within the same year (or by an extended due date)—qualify for a penalty exception, though earnings on these contributions do not.

Exceptions for 401(k) Plans Only

Exempt from the penalty are 401(k) withdrawals used for payments under a qualified domestic relations order, a dividend pass-through from an Employee Stock Ownership Plan, and corrective distributions (and associated earnings) of excess contributions and deferrals. As previously mentioned, employees who separate from the employer sponsoring their plan during or after the year the employee reaches age 55 do not face the 10% penalty.

Other Retirement Plans

Savings Incentive Match Plans for Employees (SIMPLE) IRAs and Salary Reduction Simplified Employee Pension Plans (SARSEPs), types of IRA-based employer-sponsored plans, include an exception to the penalty for permissive withdrawals from plans with automatic enrollment features. SIMPLE IRA distributions face a 25% early withdrawal penalty if made within the first two years of participation. Otherwise, IRA-based plans generally follow the same early withdrawal rules as IRAs.

Other employer-sponsored retirement plans, such as 403(b) plans and the federal government's Thrift Savings Plan, generally follow the same early withdrawal and penalty exception rules as 401(k)s, whereas 457(b) plans allow participants to take distributions in certain situations akin to hardship distributions described as *unforeseeable emergencies* (26 C.F.R. §1.457-6).

For Additional Information

- CRS Report 98-810, *Federal Employees' Retirement System: Benefits and Financing*.
- Internal Revenue Service, *Hardships, Early Withdrawals and Loans*, at https://www.irs.gov/retirement-plans/hardships-early-withdrawals-and-loans.
- Internal Revenue Service, *IRS Publication 590-B* (2018), at https://www.irs.gov/pub/irs-pdf/p590b.pdf.
- Internal Revenue Service, *Retirement Topics – Exceptions to Tax on Early Distributions*, at https://www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-tax-on-early-distributions.

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