MAKING EARLY IRA WITHDRAWALS WITHOUT PENALTY

Normally, withdrawals before age 59 1/2 from an individual retirement account (IRA) or a qualified retirement plan such as a 401(k) or pension plan are subject to not only income taxes, but a 10% penalty. For example, a taxpayer aged 54 who withdraws $10,000 from an IRA might pay a total of $3,800 in taxes and penalties ($2,800 in taxes assuming a 28% tax bracket and a $1,000 premature withdrawal penalty). But there are important exceptions to this rule that can eliminate the penalty (but not the taxes).

The first two exceptions are ones that most people would just as soon not experience: total and permanent disability and death (at which point the IRA or qualified plan balance is distributed to your beneficiary or estate). A third exception applies if you turn 55 in the calendar year you retire from your company; you can make withdrawals from the company-sponsored retirement plan (but not an IRA) without penalty.

A fourth exception allows you to withdraw early even from an IRA, which can be beneficial for those who need or want the money early because they've lost their job, have chosen to retire early, or simply need cash. This last exception is done by taking what the tax law calls substantially equal periodic payments (made at least annually), or more simply, level payments. This allows you to take out cash but leave the bulk of your funds in the account to continue to grow tax deferred.

The IRS allows you to choose one of the three methods to determine how large those payments will be.

Life Expectancy. Divide the total amount in the account by your life expectancy or the combined life expectancies of you and the account's beneficiary according to IRS tables (Publication 590). Usually this provides the smallest periodic payment.

Amortization. You amortize the payments by choosing a "reasonable" interest rate. "Reasonable" is open to interpretation. Choose one too high or too low and the IRS might dispute the rate. Picking something close to prime rate would probably be safe, but you might want to discuss the rate with your financial advisor before choosing. This method generally will pay more than the life expectancy method.

Annuity. Here, you use an insurance company mortality table instead of the IRS's tables. Typically, you'll receive higher payments than using the IRS tables.

Whatever method you choose, the payments must remain equal. Increase or decrease the payments at any time after you start withdrawals and you'll be penalized as if you'd never had the exception in the first place. However, the good news is you have some flexibility in how long you must make these withdrawals. Once you start, you must take out the payments for at least five

years or until you turn 59 1/2, whichever is longer. For example, if you start at age 50, you must take out equal payments until you turn 59 1/2. If you start at age 56, you must make the periodic withdrawals until age 61. After that, you can take out whatever amount you want without penalty or you can stop payments all together until you must start minimum withdrawal payments by April 1 of the year following the year you turn 70 1/2.

Another piece of good news is that you can treat each IRA or retirement account separately under Internal Revenue Code Section 72(t). You can take from only one or two and leave others alone, if you want, or you can start withdrawing from different accounts at different times.

Using the level payment method probably won't make sense if the retirement account is small. An it typically is better to let tax-deferred accounts grow untouched as long as possible. You may have other taxable sources for funds that would be better to tap. Talk with a Certified Financial Planner practitioner to asses all your options