Penalty-Free IRA Withdrawals

Quick-Take: In IRS Notice 2024-55 the IRS provides guidance on the SECURE Act 2.0's penalty exceptions for withdrawals from IRS and qualified plans for emergency expenses and for victims of domestic abuse, both of which are effective in 2024.

SECURE Act 2.0: This Act created two new exceptions to the early distribution excise tax when retirement funds are accessed prior to age 59 ½.

Emergency Expenses: This exception from the 10% excise tax is for any unforeseeable or immediate financial need relating to necessary personal or family emergency expenses. However, it allows only one penalty-free withdrawal in a calendar year, and it is limited to only $1,000. In addition, if such a withdrawal is taken by the IRA owner or plan participant, another one cannot be taken for another three calendar years. This last condition can be circumvented either of two different ways: (i) either after taking the first withdrawal, it is fully repaid; or (ii) by making contributions to the IRA or retirement account at least equal to the first emergency withdrawal. Repayment must be made within three years to the IRA or qualified plan account. If the withdrawal is taken from a qualified plan account, the plan will relay on a statement from the plan participant certifying that he/she is eligible for the emergency expense exception.

A qualified plan sponsor is not required to offer this option for emergency expense withdrawals. If a qualified plan does not adopt this emergency expense option, but it does permit hardship withdrawals, the plan participant can take the hardship withdrawal and treat it as a penalty-free withdrawal and claim the 10% penalty exception on Form 5329.

Domestic Abuse Victims: This exception from the early distribution excise tax is for withdrawals taken by victims of physical, psychological, sexual, emotional, or economic abuse by a spouse or domestic partner. To qualify, the withdrawal must be taken within one year of the abusive act. The amount that can be withdrawn without penalty is up to $10,000 (which is indexed for inflation), but not more than 50% of the IRA or vested qualified plan account balance. Like the emergency expense exception, a domestic abuse withdrawal can be repaid within three years. A qualified plan is not required to adopt this exception. If the exception is part of a qualified plan, a plan participant can self-certify to the plan administrator that he/she meets the eligibility requirement and will automatically apply.

Conclusion: Remember, that while the excise tax can be avoided, the distribution under either exception will still constitute taxable income. And while it is nice to have these penalty-free exceptions when taking a distribution from an IRA or a qualified plan account, it is also important to remember that there will be fewer funds available when retirement is reached.

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