taxanalysts tax facts

from the Tax Policy Center

Penalties on IRAs and 401(k)s

By Peter R. Orszag

The leading policy goal for 401(k)-type plans and IRAs is to help families accumulate wealth for retirement. Given this objective, policymakers have created tax penalties for either withdrawing funds too quickly (before age 59½) or too slowly (after age 70½). This column explores those tax penalties.

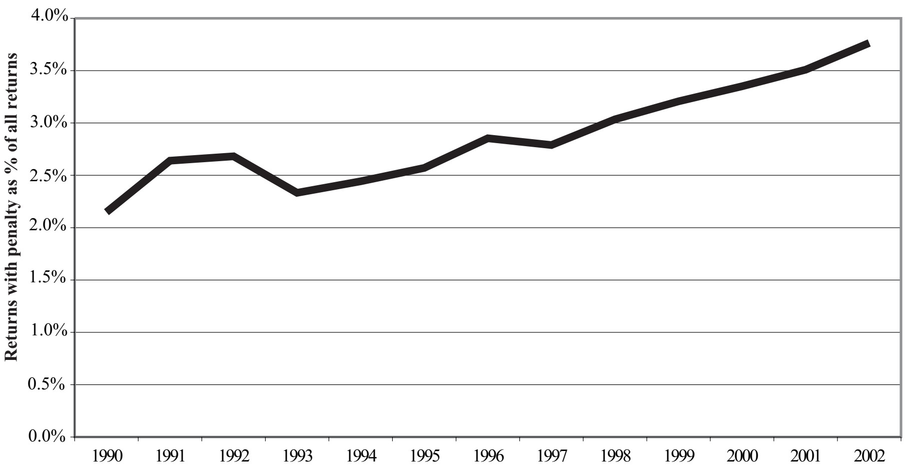
Both IRA and pension plan distributions can trigger a penalty tax on preretirement withdrawals. IRAs allow owners to take withdrawals at any time. However, unless they satisfy a specific set of exceptions, withdrawals from traditional IRAs that are made before age 59½ are generally subject to a 10 percent early withdrawal tax in addition to regular income taxes. Withdrawals from a Roth IRA that reflect investment earnings, rather than the return of principal contributions, may also trigger the 10 percent early withdrawal penalty. And employees who receive a lump sum distribution from a 401(k)-type plan or other pension after leaving a job may face the 10 percent tax if they are younger than age 59½, fail to roll the funds over to a new plan or to an IRA, and do not meet one of the legislated exceptions to the penalty.

The minimum distribution rules, by contrast, can impose a penalty on those who fail to take out sufficient amounts *after* age 70½. These rules are intended to ensure that the tax advantage associated with IRAs and pensions is used to finance retirement needs, not to build up estates.

IRS data show that in tax year 2002, 4.9 million tax returns reported a penalty tax on IRAs or pension plans. The total penalties amounted to $3.5 billion. In the same year, 31.1 million returns had taxable distributions from IRAs or qualified pension plans, and the taxable distributions totaled almost $450 billion.

The figure shows that the share of all returns with a penalty has risen steadily over the past decade. The recession of the early 1990s appears to have generated a modest increase in penalties, likely linked to preretirement withdrawal activity. Since the mid-1990s, the share of all returns with a penalty has risen fairly steadily, from 2.3 percent in 1993 to 3.8 percent in 2002.

Share of Returns With IRA or Pension Penalties



Source: Author's calculations based on statistics of income data.