The Rollover Consulting Group

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Individual Retirement Answers

Meeting Immediate Financial Needs with 72(t) Distributions

How 72(t) Distributions Work

Did you know that you can access the money in your retirement plan or Individual Retirement Account (IRA) without incurring an early withdrawal penalty?

72(t) distributions refer to Section 72(t) of the Internal Revenue Code (IRC), which deals with early distributions from retirement plans and IRAs. In addition to ordinary income taxes, withdrawals prior to age 59½ are typically subject to a 10% early withdrawal penalty. However, under Section 72(t) there are ways for investors, of any age, to avoid the 10% penalty, provided certain criteria are met.

Types of 72(t) Distributions

Under Section 72(t) there are several exceptions whereby the 10% early withdrawal penalty is waived. It's important to note that, while the 10% penalty is waived, all applicable taxes on distributions must be paid.

Qualified pension, profit-sharing, 403(b), 401(k), and SIMPLE 401(k) plans allow 72(t) withdrawals for:

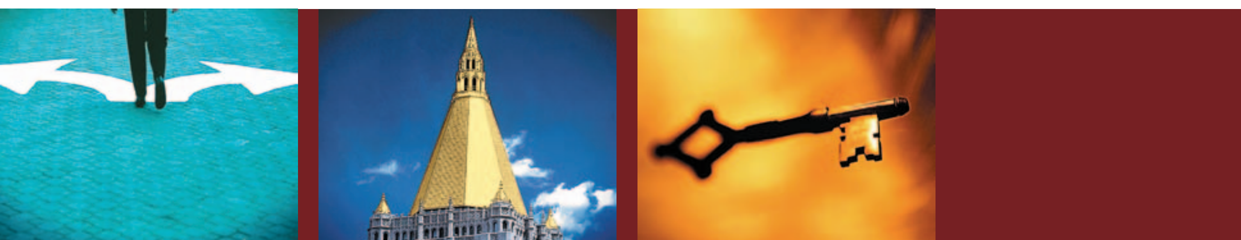
- Death distributions from the decedent's account
- Disability, as defined by the IRS
- Separation from service, during or after the year in which you reach age 55
- Certain qualifying unreimbursed medical expenses, exceeding 7.5% of Adjusted Gross Income (AGI)
- Payments received due to a Qualified Domestic Relations Order (QDRO)
- Substantially Equal Periodic Payments (SEPPs)
- Federal tax penalties if levied from the plan under Section 6331 of the Internal Revenue Code

Traditional IRAs, Roth IRAs, SIMPLE IRAs[1], and SEP-IRAs allow the early withdrawal penalty to be waived for death, disability, certain medical expenses, and SEPPs. They also allow the following 72(t) distributions:

- Purchase of a primary residence, up to $10,000 (first time home buyers, or if there has been at least two years since previous home ownership)
- Qualified higher education expenses for qualified individuals
- Health insurance premiums while unemployed, provided certain criteria are met
- Federal tax penalties if levied from an IRA

Whereas some of the distributions mentioned require a particular situation to take advantage of the penalty exception, Substantially Equal Periodic Payments (SEPPs) can generally be taken by anyone eligible for distributions. The IRS has specified that "periodic payments" mean at least one payment per year. Once the distributions begin, the account owner must take payments for the equivalent of five years, or until the owner is 59½, whichever period is longer. Once the longer period is over, the owner is free to change the payment amount, or stop withdrawing money altogether. Please consult with your financial professional for additional information about these exceptions as well as other exceptions permitted under Section 72(t).

1. For SIMPLE IRAs, the early withdrawal penalty during the first two years of participation is 25%. After the two year period, the penalty is 10%.



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72(t) Benefits

While withdrawing money from an account that is earmarked for retirement is generally not encouraged, there are certain circumstances when it's necessary. For example, if you're between jobs you may be tempted to "cash out" your retirement plan account and use the money. However, doing so might jeopardize your long-term financial goals and significantly reduce your savings. 72(t) withdrawals allow you access to the money you need for your given situation, while avoiding the 10% penalty.

If you want to take SEPPs, but your former employer's retirement plan does not allow for a prolonged payment schedule, you can still do so by rolling the account into an IRA and taking distributions under 72(t). This allows you the best of both worlds—income to meet your immediate needs and continued tax-deferred investing for a portion of your assets.

72(t) Substantially Equal Periodic Payments in Action

To gain a better understanding of how 72(t) Substantially Equal Periodic Payments work, consider the hypothetical case of a 45-year-old investor, John. He was recently laid off from his job and has $150,000 in his retirement plan. With his uncertain job status and a host of bills to pay, his first reaction is to take his money in cash. At the same time, he understands the importance of saving for retirement and not jeopardizing his retirement nest egg.

If John takes a lump sum distribution, it will reduce his $150,000 to $93,000 after the early withdrawal penalty and federal income taxes.[2] However, if John rolls his balance directly into an IRA, he'll initially have the entire $150,000 growing on a tax-deferred basis. He can then take 72(t) SEPPs using one of three calculation methods.

The *Required Minimum Distribution* method takes into consideration the balance of the account each year and generally produces the lowest payout of the three methods. The calculation is accomplished by taking the account balance and dividing it by the applicable divisor from one of the three IRS life expectancy tables: Single Life Table, Uniform Lifetime Table, or Joint and Last Survivor Table. It also allows the investor to alter the payments after the later of five years or age 59½.

The second method, *Fixed Annuitization*, can be calculated by using an annuity factor[3] and a reasonable interest rate.[4] It can also be accomplished by purchasing an immediate annuity based on single or joint life expectancy. Annuities are usually irrevocable, so if an annuity is purchased even after the end of the five years or age 59½, the distributions will generally not be able to be altered.

The third method is *Fixed Amortization*, which takes into account the value of the account in the first distribution year, a reasonable interest rate[4], and the number of payments (based on either single or joint life expectancy).

2. Hypothetical example assumes a 10% early withdrawal penalty, and a 28% federal income tax rate.
3. The annuity factor is to be derived using the IRS mortality table specified in Appendix B of Revenue Ruling 2002-62.
4. In 2002, the IRS issued new rules stating that a reasonable interest rate is not more than 120% of the federal mid-term rate for either of the two months immediately preceding the month in which the distribution begins.

Let's assume John wants to use the Required Minimum Distribution method and decided to use the Single Life Table. He would calculate his distribution amount by dividing his account balance of $150,000 by the appropriate divisor on the table. In John's case, the divisor is 38.8, so his distribution amount would be $3,866 ($150,000 ÷ 38.8). He can use this $3,866 to help cover his expenses this year without paying the 10% early withdrawal penalty. This money of course, would be subject to applicable taxes.

Once payments begin, John must stick to the payment schedule and can not make contributions to the account, or take additional withdrawals from the account. Because John chose the Required Minimum Distribution method, the payment amount will be based on John's account value and his life expectancy, thus this amount will most likely change each year. If John had chosen either the Fixed Amortization or the Fixed Annuitization method, the payments would be fixed.[5] If the periodic payments are modified—other than by reason of death or disability—the 10% penalty, plus interest and possible additional underreported tax penalties, will be imposed on all payments previously received. Once he gets a new job and doesn't need the money to pay bills, he can then take his annual distributions (that must continue for at least 14½ years, until he is 59½) and invest that money to help rebuild his retirement nest egg.

Learn More about 72(t) Distributions

As you have seen, 72(t) distributions can be a valuable tool to help you meet immediate income needs while at the same time continue saving for retirement. To learn more, speak with your financial professional. He or she can review your situation and determine whether 72(t) distributions are right for you, given your individual circumstances.

5. Recent tax law changes may permit a one time change to the Required Minimum Distribution method. Please refer to Revenue Ruling 2002-62.

Looking for more information on 72(t) distributions? Visit The Rollover Consulting Group's web site at www.rolloverconsultinggroup.com for access to a 72(t) calculator. The site also features additional calculators and helpful retirement information.

In developing a strategy for your retirement plan, your financial professional can access the resources of The Rollover Consulting Group—an experienced group of retirement consultants who understand the nuances of retirement planning. With guidance from your financial professional and The Rollover Consulting Group, you have the opportunity to maximize your retirement savings. The Rollover Consulting Group's services are provided by New York Life Investment Management LLC, a wholly owned subsidiary of New York Life Insurance Company.

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