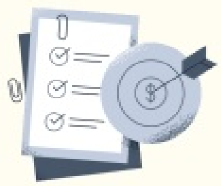

Financial Planning Topic of the Month

By: Taylor Ledbetter

If you own a retirement account, you are probably familiar with the early withdrawal penalty. This rule states that if funds are withdrawn from a retirement account before age 59 ½, there is a 10% penalty. The penalty applies to IRA accounts and other tax-advantaged retirement accounts like a 401(k) and 403(b). However, if you are trying to retire early and need access to your accounts for income, there are a few exceptions to avoid this penalty. The exception I want to cover today is called a section 72(t) distribution, also referred to as substantially equal periodic payments (SEPPs).

This exception allows you to withdraw a fixed amount of money every year for the greater of five years or until you turn 59 ½. This amount needs to be taken every year, or else you will owe a 10% penalty on all funds that were withdrawn prior. The amount you elect to take every year cannot be modified until the latter of reaching age 59 ½ or five years from the date of the first distribution. This means if you start SEPPs at age 50, a withdrawal needs to be taken until you reach age 59 ½ and there can be no modifications until this time.

There are three different calculation methods for determining the value of a SEPP.

1. The RMD method.
2. The amortization method.
3. The annuity method.

If using the RMD method, payments are calculated the same way an RMD is determined. Each year, the account balance is divided by the number from the corresponding life expectancy table for that year. The amortization method will amortize the account balance over another life expectancy factor, and an interest rate is applied to determine the payment. As a result, the withdrawal amount will generally be larger than the amount provided through the RMD method. The annuity method uses an annuity factor instead of a life expectancy factor, typically resulting in the highest payment out of the three methods.

72(t) Distributions

The clear benefit of a 72(t) distribution is the 10% penalty avoidance on an early withdrawal. While this is an excellent option for early retirement, there are always pros and cons. One con I touched on briefly is that you cannot take any additional money from your retirement account without triggering a retroactive tax. One strategy to avoid this situation is splitting up assets into multiple IRAs and establishing a SEPP from just one of those accounts. This allows other IRA assets to be available for distribution without triggering the retroactive tax.

Whether a 72(t) distribution suits you depends on multiple factors. These include retirement age, income needs, tax bracket, and other income sources. If you are considering taking 72(t) payments, you also need to consider how this may impact income in your later retirement years. With multiple factors to consider, planning properly and strategically is essential if you choose this route.