



SUBSTANTIALLY EQUAL PERIODIC PAYMENTS RULE 72(t)

Rule 72(t) may be a financial term you've rarely heard of, but it can be a great resource for those considering early retirement – either because you're ready to leave the workforce or your employer has given you the option to retire early. Internal Revenue Code Section 72(t) allows IRA owners and QRP participants under age 59 ½ to withdraw income from their IRA or QRP over a period of time and avoid the premature distribution penalty. So what is a 72(t), how does it work, and what should you consider before making a decision? With more people entering retirement early these days, here are some important features to keep in mind if you're considering taking an early retirement.

Background

Generally, a 10% penalty is assessed on distributions taken from an IRA or QRP¹ prior to age 59 ½. However, there are several exceptions to the penalty, such as death, disability, first-time homebuyer, qualified higher education expenses, birth or adoption of a child, certain medical expenses, and medical insurance, and an exception commonly known as Rule 72(t).

The Program

IRA owners and QRP participants receive distributions based on their age, account value, current IRS mid-term applicable federal interest rates, and the IRS life expectancy table that is selected, through a scheduled series of periodic payments (not less frequently than annually) that continue unaltered for five years or until the participant reaches age 59½, whichever is longer.

Example: If an IRA owner turns age 50 and begins taking substantially equal periodic payments, that individual must continue payments until reaching age 59½ (nine-plus years). If an IRA owner is age 58 when payments begin, that individual must continue payments for five full years (until age 63).

The five-year rule is waived at death or disability, and the program ends.

Structuring of Payments

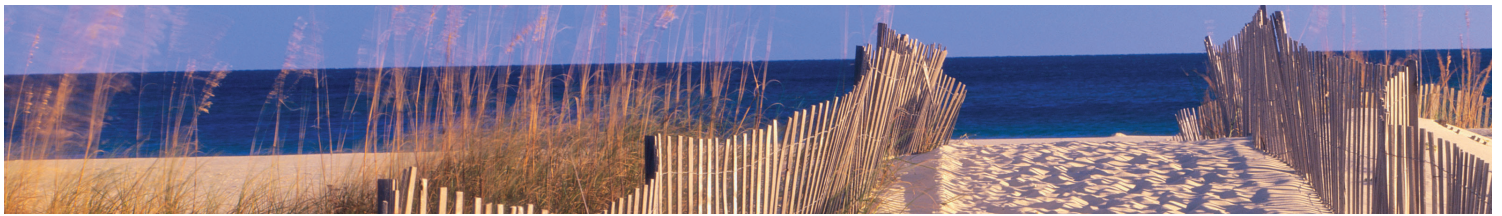
There are three methods approved by the Internal Revenue Service (IRS Notice 89-25) to determine payments that will qualify as “substantially equal periodic payments,” which are:

Method 1: Required Minimum Distributions (RMDs)

Using this method, payments are determined by dividing the individual's IRA or QRP balance by his or her life expectancy. An individual may choose from one of three IRS tables to determine his or her distribution (single, joint life, or uniform). Once a table is selected, that same table must be used to determine each subsequent year's distribution.

Example: An individual intends to begin taking distributions this year and decides to use his December 31 balance from the previous year of \$100,000. He is single and will turn age 55 in the year of the first distribution. Using the Single Life Expectancy Table, he determines that his single life expectancy is 31.6 years. His payment is calculated by dividing \$100,000 by 31.6, resulting in an annual payment of \$3,165. For subsequent years, the individual will “recalculate” each year's payment by using the IRA value on December 31 of the prior year and the newly determined life expectancy factor in the Single Life Expectancy Table.

¹72(t) payments from a QRP for participants may not begin until separation from service, depending on the plan's provisions. The 10% premature withdrawal penalty is waived for QRP distributions when the participant has separated from service after reaching age 55.



Method 2: Fixed Amortization

The payments under the fixed amortization method are determined by amortizing the IRA or QRP balance over the single life expectancy of the individual, the joint life expectancy of the individual and the designated beneficiary, or the life expectancy found in the uniform lifetime table. Any interest rate that is not more than 120% of the federal mid-term applicable interest rate (or 5%, whichever is more), declared over the preceding two months, may be used.

Example: An individual is 55 years old and has a balance of \$100,000 in his IRA on the day he intends to take his first distribution. He determines that 120% of the mid-term applicable interest rate is 5.00%. Factoring in the 5.00% rate of return and a single life expectancy of 31.6 years, the calculated annual payment will be \$6,361 per year over the scheduled period of distributions (subsequent year's payments are not recalculated).

Method 3: Fixed Annuitization

A third alternative is to divide the IRA or QRP balance by an annuity factor. The factor is determined based on the present value of an annuity of \$1 per year beginning at the individual's age attained in the first distribution year and continuing for the life of the individual. This factor is determined by using an interest rate that is not more than 120% of the federal mid-term applicable interest rate (or 5%, whichever is more) declared over the preceding two months.

Example: Using 5.00% as the mid-term applicable interest rate and the single life table, a 55-year-old IRA owner with a \$100,000 balance would receive annual distributions of \$6,286 per year over the scheduled period of distributions (subsequent year's payments are not recalculated).

To calculate payments using the fixed annuitization method, a tax advisor or an actuary should provide the appropriate annuity factor table.

Modification of Payments

Once a 72(t) payment schedule is established and payments begin, the series of payments cannot be modified in any way. If they are modified (other than by reason of death or disability), the 10% early distribution penalty would be applied retroactively, beginning with the first distribution.

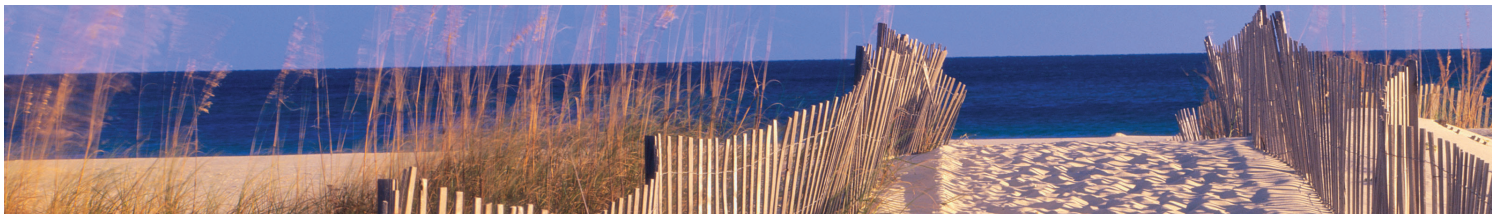
However, if as a result of following an acceptable method of determining substantially equal periodic payments, the assets in an individual's retirement plan account or IRA are exhausted, no additional income tax or penalties will be due.

Taxpayers who have an existing 72(t) program and are using the "fixed amortization" or the "fixed annuitization" method to compute their payments may make a one-time irrevocable switch to the "RMD" method. The change in method will not be considered a "modification"; thus no penalties will apply.

Changes to Account Balance

Under all three methods, 72(t) payments are calculated with respect to the account balance established prior to the first 72(t) payment. This means that a modification to the 72(t) program will occur if, after the starting date, there is:

- Any additions to the current account balance other than gains or losses;
- Certain nontaxable transfers of a portion of the account balance to another retirement plan;
- A rollover by the taxpayer of a 72(t) payment received resulting in such amount not being taxable; or
- Any additional distribution from the account outside the 72(t) distribution.



Questions and Concerns

Q. What interest rate may be used for the “fixed amortization” or “fixed annuitization” methods of calculations?

A. The interest rate that may be used is 5% or any interest rate that is not more than 120% of the IRS Applicable Federal mid-term rate (determined for either of the two months immediately preceding the month in which the distributions begin). The “Index of Applicable Federal Rates” may be found at: <https://apps.irs.gov/app/picklist/list/federalRates.html>

Q. How do I determine my balance for my first distribution?

A. The balance to be used must be determined in a reasonable manner based on the facts and circumstances. It would be reasonable to determine the yearly account balance based on the value of the IRA on any day from December 31 of the prior year to the date that the first distribution will occur. If assets were transferred or rolled into the IRA or plan, the account balance used in the 72(t) distribution calculation should be considered following the transfer or rollover. For subsequent years, the same valuation date should be used.

Q. Does an individual who has more than one IRA or QRP have to include all IRA and QRP balances in the program?

A. It is not necessary to take distributions from other IRAs or QRPs or to consider their balances when determining substantially equal periodic payments (Private Letter Ruling (PLR) 8946045).^{*} An individual is eligible to establish a 72(t) distribution based on a single account even if he or she owns other IRAs or QRPs. Distributions from the other (non-72(t)) accounts will have no impact on the 72(t) distribution schedule.

Q. When using one of the three methods suggested by the IRS to determine payments, which life expectancy table must I use to determine my distribution?

A. An individual, regardless of marital or tax filing status, may choose from one of three tables to determine his or her distribution:

1. The uniform lifetime table – This table projects the life expectancy period using the age of the participant and assumes a beneficiary that is 10 years younger.
2. The single life expectancy table – This table projects the life expectancy period based on the participant’s age only.
3. The joint and last survivor table – This table projects the life expectancy period based on the actual ages of the participant and the oldest person named as a beneficiary.

Q. Must payments be structured over a calendar year, or may an alternate 12-month period be used?

A. In PLR 9021058, an individual was allowed to use the 12-month period from December 15 to December 14. It appears an annual measuring period other than a calendar year may be used.^{*}

Q. May payments in the first year be based on the number of months remaining in that year?

A. Yes. The first year’s payments may be based on the number of months remaining. In PLR 9049044, the IRS allowed an IRA owner to pro rate the first payment rather than take a payment based on a full year.^{*} While prorating a first year’s payment is allowed, if a 72(t) program begins mid-year and the individual is accounting for it on a calendar year basis, the full annual 72(t) distribution amount may be taken during that first, partial year. A prorated distribution is not required, but is optional.

Q. Once substantially equal periodic payments begin, can additional distributions (in excess of the structured payments) be taken from the same account, provided the 10% early distribution penalty is paid?

A. No. Any additional distributions exceeding the structured payment amount would be viewed as a modification of the payment schedule. The 10% early distribution penalty would be assessed retroactively.

Q. Can I complete a partial rollover from an IRA on which 72(t) payments have already been established?

A. Yes. SECURE Act 2.0 removed the provision that completing a partial rollover from an IRA on which a 72(t) has been established counts as a modification to the structured payment amount. Individuals will be allowed to make such transfers and rollovers as long as the total distributions from the two accounts equal the correct 72(t) amount.

Penalty-Free Means Playing by the Rules

If you retire early and want to take withdrawals from an IRA or QRP prior to age 59½, one way you can avoid paying the 10% premature distribution penalty is by taking substantially equal periodic payments (Rule 72(t)). However, qualifying for this exception may be complicated, and it’s important that you understand and follow all the rules. For this reason, it is imperative to talk to your qualified tax preparer or CPA first about 72(t) distribution rules and the potential impact on your tax return.

Stifel Can Help

Your Stifel Financial Advisor and Stifel’s Retirement Plan Services Department are well educated in the substantially equal periodic payment program and can offer expertise to you. In addition, Stifel can help you determine if the 72(t) program will help you pursue your retirement income needs and goals. Contact your Stifel Financial Advisor for additional information today.

^{*}Private Letter Rulings may only be relied upon by the person who requested that ruling, and oral interpretations from the IRS cannot be relied on as authoritative guidance.

This information is from sources believed to be reliable, but its accuracy is not guaranteed. All material and hypothetical examples are for educational purposes only, and it is always recommended that you seek the aid of a competent tax advisor or tax attorney who may assist you with proper tax advice and guidance. 1224.7428104.1