

A Taxing Decision – IRA Withdrawals before Age 59.5

Two Unique Situations

One of our clients, who is still a few years from retirement, recently decided to tap his IRA as a means for financing the purchase of a Florida ocean-side vacation/retirement condo. Although he was aware that funds withdrawn would be subject to regular income tax, he felt confident that the expected appreciation on the condo would more than compensate for the accelerated tax cost. In this case, his objective was to withdraw the largest amount possible.

Another client took early retirement at age 52 and needed to draw from the substantial savings in his IRA to supplement other sources of retirement income. Here, a smaller amount was needed to meet his income requirements and he expected to be in a lower tax bracket.

There was one problem common to each instance – both clients are under the age of 59.5. That is the magic age at which the IRS will normally allow IRA withdrawals without assessing an additional early-withdrawal penalty of 10 percent. There are, however, exceptions to the general rule, which allowed both clients to achieve their individual financial goals without penalty.

Internal Revenue Code Section 72(t)

Internal Revenue Code Section 72(t) and IRS Notice 89-25 spell out the provisions whereby a retiree may take withdrawals from a qualified retirement plan before age 59.5 and avoid the 10 percent penalty tax.

Normally a withdrawal before the age of 59.5 is taxed twice – at ordinary income rates in the highest tax bracket of the IRA owner, plus a 10 percent non-deductible excise tax that works as a penalty. This does not include any state income taxation, which could push total taxes beyond 50 percent.

The 10 percent penalty will not apply to distributions:

1. made to a beneficiary, or the individual's estate, on or after the death of the individual.
2. attributable to the individual's disability.
3. made for medical care, but only amounts in excess of 7.5 percent of the individual's adjusted gross income.
4. made by unemployed individuals for the payment of health insurance premiums. (rules apply for exception to the 7.5 percent floor described above).
5. made to pay "qualified higher education expenses" during the taxable year for the taxpayer, the taxpayer's spouse and the child or grandchild of the taxpayer or the taxpayer's spouse.

6. that are “qualified first-time homebuyer distributions.” This exception to the 10 percent penalty is not available if the withdrawal qualifies for one of the other exceptions provided under IRC Section 72(t)(2), IRC Sec. 72(t)(2)(F).
7. that are part of a series of substantially equal periodic payments made, at least annually, for the life or life expectancy of the individual or the joint lives or joint life expectancy of the individual and his designated beneficiary.

This last exception is the focus of our attention.

Choosing the Right Method for Calculating the Withdrawal Amount

The IRS has approved three methods, explained below, under which payments will be considered to be “substantially equal periodic payments.” Regardless of which method is used, the series of payments must continue for the longer of five years or until the individual reaches age 59.5. Ordinarily, a “modification” that occurs before this duration requirement is met will **result** in the penalty and interest being imposed on the entire series of payments, in the year the modification occurs. However, a “one-time election” to change methods is permitted if certain requirements are met. (Both are described in more detail below.)

The specific way calculations are to be made has been clarified and the rules tightened in recent years. The three approved methods as more clearly defined in IRS Revenue Ruling 2002-62 are as follows:

Required minimum distribution, or RMD, method. The annual payment for each year is determined by dividing the account balance for that year by the number from the chosen life expectancy table for that year. Under this method, the account balance, the number from the chosen life expectancy table and the resulting annual payments are redetermined for each year. If this method is chosen, there will not be deemed to be a modification in the series of substantially equal periodic payments, even if the amount of payments changes from year to year, provided there is not a change to another method of determining the payments.

The fixed amortization method. The annual payment for each year is determined by amortizing in level amounts the account balance over a specified number of years determined using the chosen life expectancy table and the IRS approved interest rate. Under this method, the account balance, the number from the chosen life expectancy table and the resulting annual payment are determined once for the first distribution year and the annual payment is the same amount in each succeeding year.

The interest rate allowed in this calculation may not be more than 120 percent of the federal mid-term rate, which is readily available online at the IRS website and currently stands at 5.43 percent for the month of December.

Fixed annuitization method: Under this method, the annual payment is determined by dividing the individual’s account balance by an annuity factor that is 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, or the joint lives of the individual and a beneficiary. The annuity factor is derived using the mortality table provided in the 2002 IRS guidance and an interest rate chosen as explained below. The account balance, annuity factor, interest rate and resulting annual payment are all determined once for the first distribution year and the annual payment is the same amount in each succeeding year thereafter.

Life expectancy tables: There are three life expectancy table options in the 2002 guidance: the single life expectancy table, the joint and last survivor life expectancy table, and the uniform lifetime table.

The range of methods, interest rate assumptions and choice of life expectancy tables allows for considerable flexibility to determine an appropriate distribution for each individual circumstance. For instance, the following calculations under the RMD and amortization methods show the wide range of possible outcomes.

RMD assumptions for 55-year-old:

Prior year-end balance:	\$100,000	
Life expectancy factor:	41.6 years	(From Uniform Life Table)
Minimum withdrawal:	\$2,403	
(\$100,000 \41.6)		

Amortization assumptions 55-year-old account owner and 53-year-old spouse:

Prior year-end balance:	\$100,000	
Joint life expectancy factor:	29.6 years	(From Single Life Table)
Maximum allowable interest rate:	5.09 percent	
Annual fixed payment amount:	\$6,610	

Seek Professional Assistance to Assure the Desired Outcome

Once set in motion, the required calculations and withdrawals must be faithfully made each year to avoid the wrath of the IRS. Any IRS-defined "modification" may trigger the 10 percent penalty tax, retroactively applied, on all withdrawals back to the very beginning – which could make for a very nasty outcome. The types of "modification" specifically mentioned in the published guidance include:

- Any additional contribution to the IRA other than investment gains and losses, *and*
- Any nontaxable transfer of a portion of the IRA balance to another retirement plan.

The rules do allow for a one-time change in withdrawal method to address changing circumstances. An individual who begins systematic withdrawals under the fixed amortization or fixed-annuity methods may change to the minimum distribution method at anytime, but only once, during the required withdrawal period. This may be helpful for an individual who needs a

larger withdrawal to start, but less in future years. Unfortunately, it doesn't work in the other direction. Any other change in method would be deemed a modification that would trigger the penalty tax.

For those looking to withdraw from an IRA before age 59.5, wish to avoid paying the 10 percent penalty tax, these IRS rules may provide the answer. However, as flexible as the rules may be, there are many traps for those inexperienced with the labyrinth tax codes and regulations. An unintentional error could be quite costly and the IRS can be very unforgiving in its application of the laws.

This is not the place for self help. Those looking to tap their IRA early should seek a qualified advisor, such as Legacy Trust, to help them through the process.