

EARLY PLAN DISTRIBUTIONS:

HOW TO AVOID THE 10% PENALTY

By Clark Blackman and Ellen J. Boling

You can withdraw money from your retirement plans before age 59½ without incurring the 10% penalty for early distributions, but it requires careful planning, and an understanding of the IRS-approved methods for determining equal periodic payments.

Individual retirement accounts (IRAs) and employer-sponsored retirement plans such as 401(k)s have become extremely popular savings vehicles for individuals because they are an effective way to build a large base of retirement dollars on a tax-deferred basis.

However, the tax deferral does not come without cost—there are trade-offs to be aware of. As a general rule, in order to get the benefit of tax-deferred growth, you cannot withdraw money until you turn age 59½. Otherwise, you may be subject to a 10% early distribution penalty on any amounts withdrawn prior to that time.

But what if you need to withdraw your money before you reach 59½?

Uncle Sam, in fact, does allow penalty-free distributions prior to age 59½ under certain circumstances. This article focuses on the exceptions to the early distribution penalty, and it explains the distribution methods that can be used to avoid the penalty if you are withdrawing funds prior to age 59½.

SOME EXCEPTIONS

Internal Revenue Code Section 72(t)(2) carves out exceptions to the 10% penalty rule for early withdrawals from tax-deferred retirement plans. Here is a summary of some of these exceptions:

- Distributions that are part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of such employee and the designated beneficiary. This option is not available from company-sponsored qualified plans unless the recipient is separated from service.
- Distributions made to a beneficiary (or to the estate of the employee) on or after the death of the employee.
- Distributions attributable to the employee's being disabled, which is defined as the inability to engage in any substantial gainful activity and can be expected to result in death or to be of long-continued and indefinite duration.
- For employer-sponsored plans, distributions taken after the employee has separated from service after attaining age 55.
- Also, for employer-sponsored plans, the portion of the early distribution used to pay for medical expenses in excess of 7.5% of adjusted gross income. This exception applies regardless of whether or not the medical expense deductions are itemized.
- Distributions used for 'qualified higher education expenses' of the employee, the employee's spouse, or any child or grandchild of the employee. Qualified higher education expenses include tuition, fees, books, and supplies required at a post-secondary education institution.
- Distributions used by qualified first-time homebuyers to pay expenses incurred of up to \$10,000. The distributed funds must be used within 120 days of withdrawal. Eligible expenses are those to buy, build, or rebuild a

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'first' home that is the principal residence of the employee, employee's spouse, or even of any child, grandchild, or ancestor of the employee.

SUBSTANTIALLY EQUAL PAYMENTS

Of the various exceptions to the early distributions penalty, the "substantially equal periodic payments" exception provides the most interesting planning possibilities.

The first step to using this exception effectively is to understand the mechanics of what actually constitutes "substantially equal" payments.

Internal Revenue Service Notice 89-25 provides a detailed description of the three acceptable methods you can use to calculate the payment stream from your accumulated funds. Each of these methods base the payments on your life expectancy or the joint life expectancies of you and your designated beneficiary.

You should be aware that once a method is selected, it cannot be changed. This means that even if you could have originally selected a higher or lower payout amount, you cannot change your mind once your payments begin. However, the good news is that the payments do not need to continue for the rest of your life. Specifically, the payment stream must continue, without modification, for the greater of five years or until you reach age 59½.

For example, if you start payments when you are age 53, you must continue the payments until you reach age 59½. On the other hand, if you start taking payments at age 57, you must continue until you reach age 62 [five years after you started them at age 57].

Beware: If you trip up on any of these rules, the 10% penalty will apply—retroactively. Amended returns for prior years are required and interest penalties will be assessed.

THE THREE METHODS

Keeping these parameters in mind, let's take a look at the following three acceptable methods outlined by the IRS (in Notice 89-25):

- Straight Life Expectancy Method,
- Amortization Method, and
- Annuity Method.

For the straight life expectancy method, you simply divide the balance in your account by either your individual life expectancy or the joint life expectancy of you and your beneficiary. [IRS Publication 590 contains life expectancy tables; Table 1 includes life expectancies for a select range of ages.] This method will give you the lowest annual payment.

The amortization method allows you to determine your payment by amortizing your account balance over your life expectancy (or the joint life expectancy of you and your designated beneficiary) at a reasonable interest rate.

There is some leeway allowed in the interest rate you use, as long as it is "reasonable" at the time you start your payments and you don't change it throughout your required payment period. Generally, you can get larger payments by assuming a higher interest rate. But beware: You will need to be able to justify to the IRS that the rate you used is a reasonable rate if you are asked. We suggest you consider the "Applicable Federal Rate" for Section 7520 annuity calculations, published monthly by the IRS; this can be found in a research library under IRS Revenue Rulings.

The annuity method is similar to the amortization method, except that instead of using IRS life expect-

ancy tables, you can use any generally accepted mortality table, such as those published by an insurance company.

PUTTING IT ALL TOGETHER

Let's take a look at how it all works. Suppose you need to pull together some additional dollars to supplement your early retirement. You've evaluated your situation and have determined that you need to tap into your IRA account for the needed funds. Your dilemma is that you have not yet reached age 59½ and you do not want to trigger the 10% early distribution penalty.

The solution? Structure a payout from your IRA according to the substantially equal payment rules described above.

Having made that initial decision, you now turn your attention to the particular method you should select. Remember, if you select the straight life method, your payout will generally be lower than if you select either the amortization or the annuity method.

In selecting the method to use, you also need to evaluate whether you will base your payout on your life

TABLE 1. LIFE EXPECTANCY DIVISORS FOR A SELECT RANGE OF AGES

Age	Single Life	Joint Life: Same Age	Joint Life:
			10 Years Younger
45	37.7	44.1	50.2
46	36.8	43.1	49.2
47	35.9	42.1	48.3
48	34.9	41.2	47.3
49	34.0	40.2	46.3
50	33.1	39.2	45.3
51	32.2	38.2	44.3
52	31.3	37.3	43.3
53	30.4	36.3	42.4
54	29.5	35.3	41.4
55	28.6	34.4	40.4
56	27.7	33.4	39.5
57	26.8	32.5	38.5

Source: IRS Publication 590

**TABLE 2. ANNUAL PAYMENTS:
THE STRAIGHT LIFE EXPECTANCY METHOD**

Beginning IRA Balance: \$100,000			
Age	Single	Joint Life:	Joint Life:
	Life	Same Age	10 Years Younger
	(%)	(%)	(%)
45	2,653	2,268	1,992
46	2,717	2,320	2,033
47	2,786	2,375	2,070
48	2,865	2,427	2,114
49	2,941	2,488	2,160
50	3,021	2,551	2,208
51	3,106	2,618	2,257
52	3,195	2,681	2,309
53	3,289	2,755	2,358
54	3,390	2,833	2,415
55	3,497	2,907	2,475
56	3,610	2,994	2,532
57	3,731	3,077	2,597

Table 2 quantifies the dollar differences between various ages and life expectancies under the straight life expectancy method for the first year's withdrawal. Remember, this method simply involves taking your account balance and dividing by the appropriate divisor. The table illustrates the bottom line on your pocketbook, assuming a \$100,000 IRA balance. For example, say you are 53 years old and elect the single life expectancy. Under this scenario, your annual payout amount will be \$3,289 ($\$100,000 \div 30.4$).

Contrast this result with the payout amount of \$2,358 if you elected to use a joint life expectancy with someone 10 years your junior ($\$100,000 \div 42.4$).

alone, your life and your spouse's, or your life and some other designated beneficiary's life.

For example, if you are looking for the lowest payout, use the straight life method with a joint life younger than yours. However, you must use the life expectancies that reflect the beneficiary designations on the IRA document. Also, realize that if your designated beneficiary is not your spouse, the IRS assumes that there is no more than a 10 year difference in your ages when calculating your joint life expectancy.

Tables 1 through 3 illustrate how your decision of which method to use can impact your payout to varying degrees.

STRAIGHT LIFE METHOD

The first two tables help illustrate the various results assuming the straight life expectancy method is used. Table 1 depicts the range of divisors used at various ages and under different life expectancies. At age 53, the divisors differ by as much as 12 between the single life expectancy and the joint life expectancy with someone 10 years your junior.

AMORTIZATION METHOD

More significant differences can arise when using either the amortization or annuity methods. If you need to generate a larger payout, these methods will help you accomplish that goal.

Remember, these methods allow you to use a "reasonable" interest rate in the calculation; the time period over which the payments are annuitized depends on the method you have chosen—if you amortize, you will use the IRS life expectancy tables, and if you choose the annuity method, you can use a generally accepted mortality table.

The calculation annuitizes your IRA balance into equal payments over the given time period using the interest rate you have determined. You can calculate this yourself using the payment factor from an annuity table found in most financial textbooks, or by using a financial calculator or computer spreadsheet.

TABLE 3. ANNUAL PAYMENTS: THE AMORTIZATION METHOD

Beginning IRA Balance: \$100,000 Interest Rate Assumptions: 5% and 8%						
Age	Single Life		Joint Life: Same Age		Joint Life: 10 Years Younger	
	5 %	8 %	5 %	8 %	5 %	8 %
	(%)	(%)	(%)	(%)	(%)	(%)
45	5,945	8,465	5,658	8,278	5,473	8,172
46	5,996	8,501	5,695	8,301	5,499	8,186
47	6,050	8,539	5,735	8,326	5,523	8,199
48	6,114	8,585	5,773	8,350	5,552	8,216
49	6,176	8,630	5,818	8,380	5,583	8,233
50	6,241	8,679	5,866	8,412	5,616	8,253
51	6,312	8,733	5,918	8,447	5,651	8,274
52	6,404	8,804	5,967	8,481	5,688	8,296
53	6,468	8,853	6,025	8,521	5,723	8,318
54	6,554	8,921	6,088	8,566	5,765	8,345
55	6,647	8,996	6,148	8,610	5,809	8,374
56	6,746	9,077	6,219	8,663	5,852	8,402
57	6,854	9,165	6,288	8,714	5,902	8,436

IRS Publication 1457, Table S, also provides single-life factors you may use.

Table 3 illustrates various first year payout amounts using both 5% and 8% interest rates under the amortization method. There are significant differences in the payout amounts depending on the interest rate you select. For example, at all ages and at all life expectancies, there is more than a \$2,300 difference in annual distributions between these two rates.

Even more dramatic is the difference in annual distribution amounts between the straight life expectancy method in Table 2 and the amortization method in Table 3. Let's go back to our earlier example at age 53 with an IRA account balance of \$100,000. Using the 5% interest rate and a single life expectancy, Table 3 shows that the amortization method allows you annual distributions of \$6,468, which is almost double the \$3,289 distribution in Table 2 using the straight life

method. If you increase the interest rate to 8%, your distribution amount increases even more significantly to \$8,853. Clearly, this method offers you a good deal of flexibility to tailor your payment stream to your needs.

DIFFERENT ACCOUNTS

There is one more very important planning strategy to keep in mind when considering substantially equal periodic payments. If you have multiple IRAs, these rules apply only to the account you designate. Therefore, you may further customize the amount you will receive by making sure the IRA chosen has the appropriate balance in it prior to the first withdrawal. Additionally, if after you begin taking substantially equal periodic payments against one account you find that you need larger distributions, you can elect to take substantially equal payments from a second account, and those payments can be calculated using a

different method.

CONCLUSION

It is possible to take early distributions from your retirement plans before age 59½ without incurring the harsh 10% early distribution penalty. But it does require some careful planning. In particular, you should have an understanding of:

- The three methods allowed by the IRS for determining equal periodic payments, and how they affect your distribution amount;
- The impact that a single life versus a joint life calculation has on your distribution amount; and
- The importance of the selection of an interest rate in the amortization and annuity methods.

Once you have analyzed these factors, you will have an appreciation of the flexibility of your options under the substantially equal periodic payments exception, and you will be on your way to tailoring a meaningful distribution plan. ♦