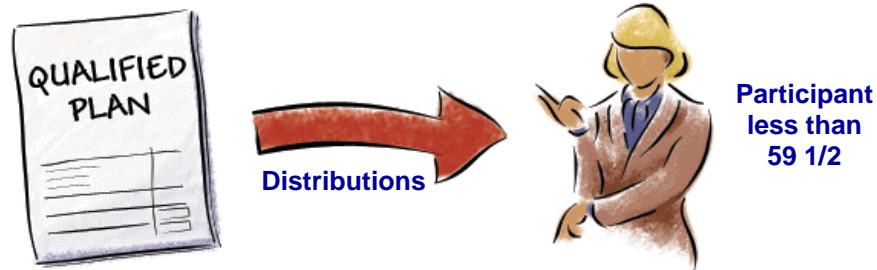


Retirement Plan Distributions Before Age 59½

IRC Sec. 72(t)



Distributions from qualified plans, 403(b) annuities, SIMPLE plans, and all IRAs may be subject to a 10% penalty tax if made before the participant reaches age 59½. The penalty tax is waived if the distribution is rolled over to an eligible recipient plan or if the participant is totally disabled or dies.¹ Since premature withdrawals are generally also subject to ordinary income tax, the extra 10% penalty could make the total tax very high.²

Possible Exceptions

There are several possible exceptions to this 10% penalty rule.

- For qualified employer plans, 403(b) annuities, SIMPLE 401(k) plans, and distributions to participants who have separated³ from employment after age 55.
- When distributions are for deductible medical expenses, or pursuant to a qualified domestic relations order, e.g., a divorce decree.
- In certain situations, premature distributions from IRAs to pay health insurance premiums for unemployed individuals may also avoid the penalty tax.
- The Katrina Emergency Tax Relief Act of 2005 (KETRA) and the Gulf Opportunity Zone Act of 2005 (GOZA) provide a temporary (until January 1, 2007) exception to the 10% penalty rule. These acts allow qualifying individuals living in areas impacted by Hurricanes Katrina, Rita, or Wilma, to withdraw up to \$100,000 penalty-free from an IRA or other qualified retirement plan. Although exempt from the 10% penalty tax, these withdrawals are subject to normal income tax.
- For IRAs there are two additional exceptions.
 - If the distribution is used to pay for qualified education expenses of the individual, spouse, child, or grandchild, then the 10% penalty tax is not assessed.
 - For a first-time homebuyer, there is a lifetime exemption of \$10,000 from the 10% penalty tax. The purchaser of the home may be the individual, a spouse, child, or grandchild. A first-time homebuyer is someone, or his or her spouse, who had no ownership in a principal residence during the preceding two years prior to purchasing the new home.

¹ Distributions before age 59½ from SIMPLE IRA plans made within the first two years of participation are subject to a 25% penalty, rather than a 10% penalty, subject to the exceptions discussed above. If a premature distribution from a SIMPLE IRA is made after two years of participation, the 10% penalty applies, subject to the exceptions. See IRC Sec. 72(t)(6).

² The discussion here concerns federal income tax law. State or local income tax law may differ.

³ For the owner of a small business, it can be very difficult to "separate" from employment.

Continued...

Retirement Plan Distributions Before Age 59½

IRC Sec. 72(t)

- One other exception, available to any qualified plan, SIMPLE, 403(b) TSA plan, or IRA participant, is the substantially-equal periodic payments exception in IRC Sec. 72(t)(2)(A)(iv).

Substantially-Equal Periodic Payments

This exception applies when the distribution is part of a scheduled series of substantially-equal periodic payments, made at least once a year, over the life (or life expectancy) of the participant, or the joint lives (or joint life expectancies) of the participant and a beneficiary. If the series of payments is subsequently modified (except because of death or disability) within a 5 year period, or, if later, age 59½, the 10% penalty will be re-applied and interest will be charged.

Calculating the Substantially-Equal Periodic Payment

In Notice 89-25, 11989-1, CB 662, Q&A-12 (March 20, 1989), the IRS listed three acceptable methods of calculating such a distribution.

- **Required minimum distribution:** The annual payment is determined using a method acceptable for calculating the required minimum distribution required under IRC Sec. 401(a)(9). In general, the account balance is divided by a life expectancy factor, resulting in a payment which fluctuates from year to year.
- **Fixed amortization method:** Payment under this method would be similar to the annual amount required to pay off a loan (equal to the amount in the plan at the start of distributions), at a reasonable interest rate, over the remainder of one's life. The dollar amount of the payment remains the same in each subsequent year.
- **Fixed annuitization:** An annuity factor is determined from a reasonable mortality table at an interest rate which is then reasonable for the age of the recipient of the distribution. The payment is determined for the first distribution and remains the same in each subsequent year.

Revenue Ruling 2002-62

On October 3, 2002, the IRS released Revenue Ruling 2002-62, to address questions raised by taxpayers who had begun to receive distributions under IRC Sec. 72(t) and who had been adversely affected by the declining stock market. This ruling contained the following key points.

- It expanded the guidance given in Q&A 12 of IRS Notice 89-25 to, among other things, incorporate into the calculation process the new life expectancy tables issued in April, 2002, with regard to required minimum distributions from IRAs and qualified plans.
- Specified that if a participant who is using an acceptable method to calculate the required substantially-equal periodic payments exhausts the assets in an account prior to the required time period, the "cessation of payments will not be treated as a modification of the series of payments."

Continued...

Retirement Plan Distributions Before Age 59½

IRC Sec. 72(t)

- Allows a participant who is using either of the fixed dollar amount methods (fixed amortization or fixed annuitization) to make a one-time change to the required minimum distribution method.

The guidance provided in Revenue Ruling 2002-62 replaces the guidance in Q&A12 of IRS Notice 89-25 for any series of payments beginning on or after January 1, 2003, and may be used for distributions beginning in 2002. If distributions began before 2003 under any method that satisfied IRC Sec. 72(t)(2)(A)(iv), the participant may change to the required minimum distribution calculation method at any time.

Comparing the Three Methods¹

Assumptions:

Plan or IRA account balance on 12/31 of the previous year: \$400,000

Age of participant in distribution year: 50

Single life expectancy at age 50: 34.2²

Interest rate assumed: 4.5%

Distribution period: Single life only

- **Required minimum distribution method:** For the current year, the annual distribution amount is calculated by dividing account balance by the participant's life expectancy.

$$\$400,000 / 34.2 = \$11,695.51$$

- **Fixed amortization method:** Distribution amount is calculated by amortizing the account balance over the number of years of the participant's single life expectancy. The calculation is the same as in determining the payment required to pay off a loan.

$$\$400,000 \times (.045 / (1 - (1 + .045)^{-34.2})) = \$23,134.27$$

- **Fixed annuitization method:** The distribution amount is equal to the account balance divided by an annuity factor that for the present value of an annuity of one dollar per year paid over the life of a 50-year-old participant. Such annuity factors are typically calculated by an actuary. In this case, the age-50 annuity factor (17.462) is based on the mortality table in Appendix B of Rev. Rul. 2002-62 and an interest rate of 4.5%.

$$\$400,000 / 17.462 = \$22,906.88$$

Method	Annual Withdrawal
Required minimum distribution	\$11,695.51
Fixed amortization	\$23,134.27
Fixed annuitization	\$22,906.88

¹ The examples shown here were taken from the IRS web site, www.irs.gov, "FAQs regarding Revenue Ruling 2002-62," 12/27/02.

² Derived from the Single Life Table found in Q&A-1 of Reg. 1.401(a)(9)-9.