Wealth Strategies

Great News for Early Retirement
New Rules for SEPP Plans & IRC Section 72t

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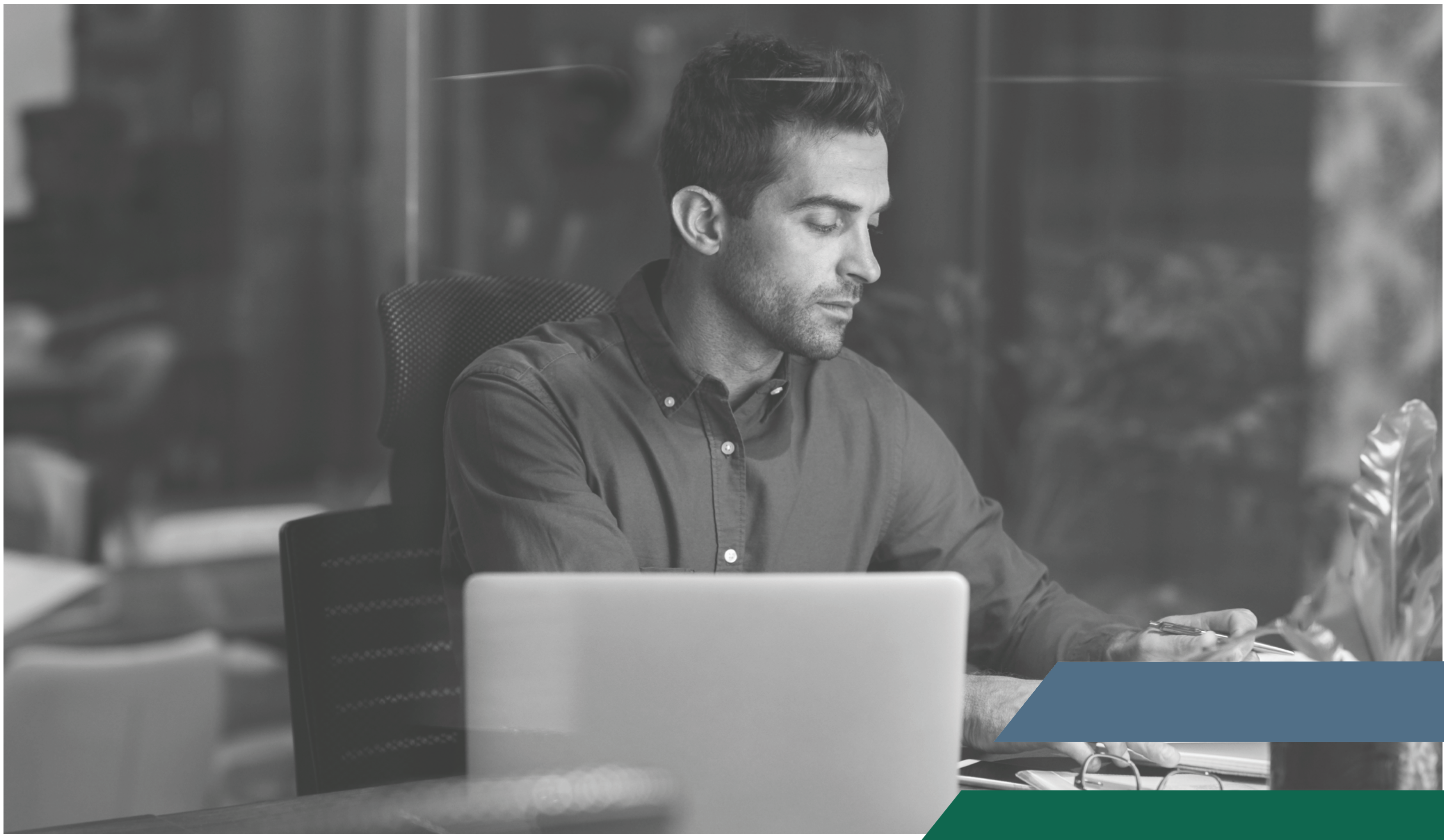

Should I stay or should I go now?
Should I stay, or should I go now?
If I go, there will be trouble
And if I stay it will be double
So come on and let me know

The 14-year-old who bought The Clash's Combat Rock album in 1981 is now 55 and thinking about going.

For some time now, many individuals interested in retiring early have been unable to take advantage of SEPP plans because of the low interest rates mandated in earlier IRS Notices.

The newly released Notice 2022-6 provides some relief. The notice provides for the use of the greater of 5% interest rate or 120% of the AFR Mid-term Rate table. (The AFR rate is 1.69% for February 2022) This higher rate vastly increases a retirees' SEPP distribution amounts.[1&2]

The Substantially Equal Periodic Payment (SEPP) rule allows you to establish a schedule of penalty-free withdrawals. It also lets you avoid the 10% penalty tax.[3]

SEPP plans are permitted under the rules established by IRC Section 72(t).[4]

Simply put, because of the changes announced in Notice 2022-6, more people can retire early and establish a penalty-free SEPP that meets their income needs.

Alternatives to a SEPP

Before we look at an example illustrating these beneficial changes, let's consider other options if you simply need the money for a brief time rather than over a period of years. First, you can always pay the 10% penalty tax and move on. But distributions taken because of the disability or death of the IRA owner avoid the penalty. So does the payment of certain medical expenses, including payment of health insurance premiums if you've been unemployed for at least 12 weeks and meet other conditions. Payment of higher education expenses, up to $5,000 in adoption expenses, and payment or IRS levies, all avoid the 10% penalty.[5] Lastly if you are leaving an employer plan (not an IRA) the rule of 55 may apply. It is another exception to the 10% penalty for early withdrawal but only if you leave your job after you turn 55 (or many times even at 50 for some public service employees). This opportunity depends on the terms of the retirement plan, so it is important to check before leaving. As

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[1]Notice 2022-6, https://www.irs.gov/pub/irs-drop/n-22-06.pdf

[2]AFR -Applicable Federal Rate, https://www.irs.gov/applicable-federal-rates

[3]Notice 2022-6 also applies for purposes of determining whether a distribution from a non-qualified annuity contract is part of a series of substantially equal periodic payments within the meaning of section 72(q)(2)(D).

[4]26 U.S. Code § 72

[5]72(t) Distributions, Morgan Stanley, February 2020

a rule of thumb, if you have old 401k's, you should investigate rolling those into a current 401k. You would want to access the funds from a current account if you had to leave your job early, otherwise the rule of 55 will not apply.[6] With those caveats in mind, let's look at an example of a SEPP plan.

Example of a SEPP

Our rebellious 55-year-old wants to stop working now. He uses the three methods available to determine possible SEPP payments. Since this is occurring in February 2022, he has the new 5% rate available, along with the recently updated life expectancy tables. His account balance is $500,000 and his spouse is 55 too. Let's compare the 5% rate and the AFR rate.

Rate Table Used	Factor	Amortization[7] (5% Rate)	Amortization (using Feb 2022 AFR)	Annuitization[8]	Annuitization (using Feb 2022 AFR)	RMD[9]
Single	31.6	$31,807	$20,550	N/A	N/A	$15,823
Joint	37.40	$29,807	$18,145	N/A	N/A	$13,369
Uniform	43.60	$28,382	$16,300			$11,468
Mortality	15.91	N/A		$31,428	$20,477	N/A
Maximum Initial Distribution		$31,807	$20,550	$31,428	$20,477	$15,823

How SEPP Plans Work

As you can see, the IRS gives you three different methods to figure out your withdrawal schedule.

When you begin taking 72(t) SEPP payments, you must stick with the payment schedule for five years or until you reach age 59 1/2, whichever comes later (unless you are disabled or die).

For instance, if you begin using the SEPP method at age 52.5 (seven years before you turn age 59 1/2), you must keep using the payment plan you set until you reach age 59 1/2. But if you begin the SEPP method at age 57, then you must follow that plan for five years or until you reach age 62.

If you depart from your schedule before that amount of time has passed, the IRS will impose a penalty tax on all amounts withdrawn up to that point.[10]

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[6] What is the Rule of 72t and 55?, Wiser Wealth, Matthews Barnett, CFP®, ChFC®, CLU®

[7] Both the Amortization and Annuitization distribution amounts remain level from year to year.

[8] See above

[9] The Required Minimum Distribution is recalculated annually, increasing the required distribution

[10] Substantially Equal Periodic Payments https://www.irs.gov/retirement-plans/substantially-equal-periodic-payments#1

Three Methods

Required Minimum Distribution (RMD)
Start by looking up your age on the appropriate IRS table. The table will then tell you what divisor to use for your age. You then divide your prior year-end account balance by the number you'll find on that IRS table, which results in your distribution for the year. (Similar to the RMD calculation used when you reach age 72.)

Using the RMD method, the annual payment for each year is determined by dividing the account balance by the life expectancy factor of the taxpayer and their beneficiary, if applicable. Under this method, the annual amount must be recalculated annually and, as a result, will change from year to year. It also generally results in lower annual withdrawals than do the other methods. You may use any of the three tables found in IRS Publication 590B. Recognizing improved mortality, the IRS just issued new tables that have lowered the required amounts so make sure you are using the updated 2022 tables.[11]

Amortization
This withdrawal method creates an annual withdrawal schedule. It is calculated just like the payment schedule on a mortgage. You take the most recently reported account balance, such as the one on your last monthly account statement and assume a reasonable interest rate. We mentioned earlier that the IRS did not allow you to use a rate greater than 120% of the mid-term, but that has now increased to 5%.[12]

Then, create an annual payout schedule based on the appropriate life expectancy table. Choose one of the following tables: single life, joint life with your non-spouse beneficiary, or uniform life. (Choose uniform life if your spouse is more than 10 years younger than you.)

Annuitization
This option uses a method just like a pension or insurance company uses to determine life annuity payout amounts. As with the amortization method, the distribution you must take under the annuitization method is also the same each year. The amount is determined by using an annuity based on the taxpayer's age and the age of their beneficiary, if applicable, and a chosen interest rate, with the same IRS guidelines as with amortization. The annuity factor is derived using an IRS-provided mortality table.

Both the amortization and annuitization options above result in a fixed annual payout amount. You must stick with that schedule for five years or until you reach the age of

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[11]Federal Register, https://www.govinfo.gov/content/pkg/FR-2020-11-12/pdf/2020-24723.pdf
[12]Supra, https://www.irs.gov/retirement-plans/substantially-equal-periodic-payments#3

59 1/2 (whichever comes later) unless you make a one-time switch to the RMD payout method.

SEPP Planning

You must use one of the methods described above to calculate the periodic payment amount of your 72(t) payments.

What if you can't use the calculator to get the payment amount you need? Then you can achieve your desired payment amounts by adjusting the balance in your IRA account. You must increase or decrease your IRA balance—through a rollover from or into another IRA, for example—before you establish your SEPP payments. Once you've started your SEPP payment schedule, you can no longer add or remove funds from your IRA.

By splitting your IRA accounts, some can be under a SEPP plan, whereas with others you can continue to contribute to an IRA and take distributions not tied to SEPP (but the 10% penalty may apply.) Leave only the minimum amount needed to produce your desired payment in accounts used to calculate the distributions.

When does the five year period end? 72(t) payments must be maintained for at least 5 full years after the date of the first distribution. If you are taking distributions annually, this DOES NOT mean that after your fifth distribution, you're done. You must wait until the end of the fifth year before making any transactions that would result in a modification.

Planning Opportunities and Pitfalls in Establishing SEPPs

Planning Opportunities	Pitfalls to Avoid
- Exploit the choice of calculation method, life expectancy table, interest rate, and account balance to establish a payment amount that meets the IRA owner's objective. - Establish the desired account balance of the SEPP IRA before initiating the SEPP by splitting or combining funds in existing IRAs. - Consider the impact of designated beneficiaries on the life expectancy measure. - Consider the opportunity to switch from either of the fixed methods to the required minimum distribution method to avoid depleting assets in a market downturn or to lower payments.	- In general, there is no termination or modification of payments except due to the death of the IRA owner or the depletion of assets. - There are no rollovers or transfers in or out of the SEPP IRA during the required distribution period. - Immediately consult your tax advisor in the event of modifications or roll-overs resulting from divorce or trustee error. - Monitor the impact of changes in designated beneficiaries on life expectancy measures in applying the required minimum distribution method. -Monitor the decline of the account balance to avoid the depletion of assets under the fixed amortization or fixed annuitization method.

As always, make sure to consult with your tax advisor before implementing any tax-related planning approach.

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