PacificCPE

COURSE
33452A

# Early Distributions and Periodic Payment Strategies

Navigating early retirement distributions without triggering unnecessary penalties requires knowing both the rules and the exceptions. This course covers the 10% early distribution penalty, the exceptions that apply, and the substantially equal periodic payment (SEPP) rules under IRC Section 72(t). You'll learn how to structure compliant payment schedules, what happens when a client strays from safe harbor guidelines, and how to advise clients who want access to retirement funds before the standard withdrawal age. Practical for any tax professional with clients in retirement or near-retirement situations.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

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## Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

## Course Objectives

- Recognize the types of retirement account distributions that avoid the early distribution tax.
- Recall the characteristics of substantially equal periodic payments.

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# Chapter 1: EARLY DISTRIBUTIONS: TAKING YOUR MONEY OUT BEFORE THE LAW ALLOWS

*Chapter Objective*

**After completing this chapter, you should be able to:**

- Recognize the types of retirement account distributions that avoid the early distribution tax.

If you take money out of a qualified plan, a qualified annuity, a tax-deferred annuity, or an IRA before you reach age 59½, your withdrawal is called an early distribution, and you'll have to pay a 10% early distribution tax on any taxable portion withdrawn, unless you can meet one of the exceptions.

This chapter describes those exceptions. It also explains how to calculate and report the tax in case your distribution doesn't fit within one of those exceptions. In addition, this chapter describes additional special rules for IRAs.

*Caution!*

**Don't forget regular income taxes.** The exceptions we describe in this chapter help you escape the early distribution tax, not income taxes.

## EXCEPTIONS TO THE EARLY DISTRIBUTION TAX

The 10% early distribution tax feels more like a penalty than a tax, and no wonder: It's the cornerstone of the government's efforts to discourage us from plundering our savings before our golden years. Fortunately, there are many exceptions to the early distribution rule. You won't have to pay the early distribution tax if any of the following apply:

- You're age 59½ or older.
- You become permanently disabled.
- You choose to take substantially equal periodic payments.
- You're a qualified reservist called to active duty for at least 180 days.
- You receive distributions that are dividends from an ESOP.
- You're at least 55 years old when you leave your job.
- You're a qualified public safety employee and you left your job after turning 50 (or after 25 years of service, whichever is earlier).

*Helpful Terms*

**Adjusted gross income (AGI).** Total taxable income reduced by certain expenses, such as qualified plan or IRA contributions or alimony payments. Note: Adjusted gross income doesn't take into account any itemized deductions (see definition below).

**After-tax contribution.** A contribution to a retirement plan or an IRA for which no deduction was taken on an income tax return.

**Ancestor.** A person from whom an individual is descended. For example, an individual's ancestors include parents, grandparents, and great-grandparents.

**Distribution.** A payout of property (such as shares of stock) or cash from a retirement plan or an IRA to the participant or a beneficiary.

**Itemized deductions.** Expenses, such as medical payments, mortgage interest, and charitable contributions, that can be used to reduce AGI to arrive at the total amount of income subject to tax.

**Principal residence.** The home in which an individual lives most of the time. ("Most" isn't defined in the tax code. It is established by your actions.)

**Separation from service.** Termination of employment.

**Standard deduction.** A fixed dollar amount that can be used instead of itemized deductions to reduce AGI before computing tax liability.

- You withdraw the money to pay medical expenses that add up to more than 7.5% of your adjusted gross income.
- You withdraw money for the purchase of long-term care insurance.
- You withdraw money to pay child support or alimony or as part of a QDRO (Qualified Domestic Relations Order).
- You use the money to pay a federal tax levy.
- You withdraw money that's actually a refund.
- You use the withdrawal to pay expenses for the birth or adoption of a child.
- You withdraw money to pay emergency expenses.
- You have experienced domestic abuse.
- You have a terminal illness.
- Your principal residence is in a qualified disaster area.
- You're no longer living and your beneficiary or estate receives distributions after your death.

You can read more about each of these exceptions in the sections below.

**Age 59½**

Although it's a little nonsensical to call being 59½ an exception to the tax on early distributions (after all, if you're 59½, your distribution isn't early in the first place), the tax code views it as an exception, so that's the way we discuss it here.

Before taking money out, make sure you'll be at least 59½ on the day of the withdrawal. Otherwise, you'll pay the tax. In other words, it's not good enough that you turn 59½ during the year of the withdrawal. You must be at least 59½ on the day that you get the funds.

*Caution!*

**Escaping the early distribution tax doesn't mean you get free access to your money.** Just because you have passed age 59½ doesn't guarantee that you can take money out of your retirement plan. Many qualified plans do not permit distributions before you terminate your employment. Reaching age 59½ simply ensures that if you are able to take money out, it won't be subject to the early distribution tax.

**Disability**

If you become disabled, you can take money out of your retirement plan without worrying about the early distribution tax.

But what does it mean to be disabled? And who decides? The law defines "disabled" as the inability to "engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration." This definition appears to be similar to the one the Social Security Administration uses when deciding disability claims, but it's actually harder to meet in some ways and easier to meet in others.

The key to the IRS's disability exception seems to lie in the permanence of the condition. And the disability must be deemed permanent at the time of the distribution, whether or not it's later found to be permanent. For example, the IRS has previously denied the disability exception for a taxpayer, even knowing that the taxpayer later qualified for Social Security disability benefits.

The IRS regulations clarify that "gainful activity" refers to the type of work you were doing before becoming disabled. The IRS will examine whether your impairments prevent you from engaging in your customary work activity, or any work activity comparable to it. So, you don't necessarily need to be unfit for all work, just work similar to what you customarily did before you became disabled.

This is an easier standard to meet than Social Security's, which requires that you can't do any type of substantial work.

Successful IRS disability claims have included a dentist who suffered nerve damage to his thumb, preventing him from doing dental work, after he produced documents from four insurance companies declaring his disability permanent. Another successful claim involved a taxpayer who had been granted a disability retirement by his company. The IRS relied on the company's determination of the individual's disability. These cases reveal that the IRS is most concerned about the timing and the nature of the disability. Using the cases as a guide, if your disability prevents you from working and is deemed permanent at the time you take your retirement plan distribution, then you should qualify for the disability exception. But there are no guarantees in this arena.

**Substantially Equal Periodic Payments**

The "substantially equal periodic payment" exception is available to anyone with an IRA or a retirement plan, regardless of age, which makes it an attractive escape hatch. Theoretically, if you begin taking distributions from your retirement plan in equal annual installments, and those payments are designed to be spread out over your entire life or the joint life of you and your beneficiary, then the payments won't be subject to an early distribution tax.

The fly in the ointment is that you aren't permitted to compute payments any way you please. The payment method must conform to IRS guidelines, which sanction three computation methods. Nonetheless, the guidelines are somewhat flexible, making the exception at once versatile and complex. For these reasons, Chapter 2 is devoted exclusively to interpreting the IRS's computational guidelines and related rulings for taking substantially equal periodic payments.

If you think you might need to tap your retirement plan early, this is the option that's most likely to work for you. One caveat: If you want to begin taking substantially equal periodic payments from your employer's plan, you must have terminated your employment before payments begin. If the payments are from an IRA, however, the status of your employment is irrelevant.

**Leaving Your Job After Age 55**

If you're at least 55 years old when you leave your job, you won't have to pay the early distribution tax on money that you take out of your retirement plan. This exception applies per employer, meaning that you can go to work for another employer and still meet this exception to your previous employer's plan.

This exception is relevant only if you're between ages 55 and 59½. After age 59½, the early distribution tax doesn't apply to any retirement plan distribution.

As with other exceptions, you must pay attention to certain details. For example, you need not be age 55 on the day you leave your job, as long as you turn 55 by December 31 of the same year. The

strategy falls apart if you retire in a year before the year you turn 55, even if you postpone receiving the retirement benefits until you reach age 55.

*Example*

You retire at age 53 and convince your employer to keep your retirement plan benefits in the plan until you reach age 55. The day after your 55th birthday, you receive $100,000 from your former employer's plan. You buy a Jaguar and spend the rest of the money on a trip around the world. At tax time, you'll owe regular income tax on the $100,000 plus a 10% early distribution tax.

If, instead, you had retired in the same year you turned 55, the $100,000 would be subject to regular income tax, but you wouldn't have to pay an early distribution tax.

*Tip*

**The age 55 exception changes for certain public safety employees participating in government plans.** Certain public safety employees who participate in government-sponsored retirement plans are able to take penalty-free distributions from their retirement plans either if they've completed 25 years of service with the employer sponsoring the plan or if they separated from service after age 50. Public safety employees include:

- Firefighters
- Federal law enforcement officers
- Federal customs and border protections officers
- Air traffic controllers
- Nuclear material couriers
- U.S. Capitol Police
- Supreme Court police, and
- State Department diplomatic security agents.

*Caution!*

**The age 55 and age 50 (or 25 years) changes described above aren't available for IRAs.** See "Special Rules for IRAs," below, for other rules that apply only to IRAs.

### Qualified Reservist Distribution

If a member of the reserves is called to active duty for at least 180 days or for an indefinite period, then distributions received on or after the date of the call to active duty, and before the end of the

period of active duty, won't be subject to the early distribution tax. This exception applies only to individual retirement accounts and to salary deferral contributions to other types of plans.

*Tip*

**Reservists can return qualified distributions to the retirement plan.** The law provides an additional benefit to those who take qualified reservist distributions. After completing active duty, members of the reserves are permitted to return some or all of the distribution they received while on active duty, as long as it's returned within two years of the end of their active duty period.

**Dividends From ESOPs**

You don't have to pay the early distribution tax on distributions of dividends from employer stock held inside an ESOP, no matter when you receive the dividends. (See Chapter 1 of course 33451G for more information about ESOPs.)

**Medical Expenses**

If you withdraw money from a retirement plan to pay medical expenses, a portion of that distribution might escape the early distribution tax. But once again, the exception isn't as simple or as generous as it sounds. The tax exemption applies only to the portion of your medical expenses that would be deductible if you itemized deductions on your tax return. Medical expenses are deductible if they are yours, your spouse's, or your dependent's. But they're deductible only to the extent they exceed 7.5% of your adjusted gross income. Consequently, your retirement plan distribution will avoid the early distribution tax only to the extent that it also exceeds the 7.5% threshold.

*Example*

You're single and your adjusted gross income is $50,000. You had medical bills of $6,000 during the year, which you paid with funds you withdrew from your retirement plan. For income tax purposes, you're permitted to deduct medical expenses that exceed 7.5% of your adjusted gross income. Thus, your calculation is as follows:

| | | |
|---|---|---|
| Adjusted gross income (AGI) | = | $50,000 |
| Nondeductible medical expenses 7.5% of AGI (0.075 × $50,000) | = | $ 3,750 |
| Deductible medical expenses excess ($6,000 – $3,750) | = | $ 2,250 |

Although you took $6,000 from your retirement plan to pay medical expenses, only $2,250 will escape the early distribution tax. The remaining $3,750 will be subject to the 7.5% additional tax (unless you qualify for another exception). And don't forget that the entire $6,000 is subject to regular income tax, as well.

On the plus side, the medical expense exception to the early distribution tax is available even if you don't itemize deductions. It applies to those amounts that would be deductible if you did itemize.

*Example*

As in the preceding example, your adjusted gross income is $50,000. You have $6,000 of medical expenses, which you paid with funds from your retirement plan. Only $2,250 of those expenses are deductible (as calculated above). Your deductible items for the year are as follows:

| | |
|---|---|
| Deductible medical: | $2,250 |
| Deductible taxes: | $1,500 |
| Charitable contributions: | $ 700 |
| Total | $4,450 |

The standard deduction for a single individual is greater than $4,450. When computing your tax liability, you're permitted to reduce your adjusted gross income by the larger of your itemized deductions or the standard deduction. In this case, because the standard deduction is larger, you won't itemize deductions on your tax return. You can still exclude $2,250 of your retirement plan distribution from the early distribution tax computation, however.