Second Quarter 2022

Overcoming Retirement Account Investing Hesitations

The more economic uncertainty, the more hesitant we find clients are to lock up funds in a retirement account. But retirement accounts are an important part of building retirement security, particularly with Social Security forecasted to be in the red by 2025.

For investors concerned that they may need access to their retirement funds prior to age 59½, it helps to know that several exemptions exist that allow early withdrawals without a 10% penalty.

Better known exceptions to the 10% penalty (subject to certain requirements) include:

- Early withdrawals for rollovers into another retirement account within 60 days,
- Medical bills in excess of 10% of the individual's adjusted gross income (AGI),
- Total and permanent disability of the account owner,
- Distribution to beneficiaries after the account owner's death,
- Qualified education expenses,
- First-time homebuyers – withdrawals up to $10,000 from an IRA,
- Health insurance premiums paid by the unemployed,
- Qualified hurricane distributions,
- Qualified reservist distributions for the military.

Another way to avoid the 10% early withdrawal penalty is **substantially equal periodic payments**.

Under IRS code section 72(t)(2)(A)(iv), distributions that are part of a series of substantially equal periodic payments (not less frequently than annually) are exempt from the 10% penalty. These payments are made for the life (or life expectancy) of the account holder or the joint lives (or joint life expectancies) of the account holder and designated beneficiary. Once a SOSEPP is started, distributions must be taken for at least five years, or until the account holder reaches age 59 ½, whichever is longer. Stopping the payments early will result in penalties and interest in most cases.

Payments are considered to be substantially equal periodic payments if they comply with one of the following three methods: (1) the required minimum distribution method; (2) the fixed amortization method or (3) the fixed annuitization method.

With method 1, the annual payment is recalculated each year, based on the account balance and account holder's life expectancy. Methods 2 and 3 use amortization or annuitization schedules to determine fixed distributions over the life expectancy of the account holder. Effective January 1, 2022, the interest rate used to apply the fixed amortization method or the fixed annuitization method was substantially increased with the addition of a 5% floor. Calculation of amortized or annuitized payments is now based on a rate not more than the greater of (i) 5% or (ii) 120% of the federal mid-term rate. Given 120% of the February federal mid-term rate was 1.67%, this new floor results in substantially higher annual payments.

Work with a qualified financial adviser or tax adviser BEFORE taking any early withdrawals from your retirement accounts. Early withdrawals can be a minefield of tax hazards. Distributions from tax-deferred retirement accounts are taxed as ordinary income and, if taken prior to reaching age 59½ without a compliant exemption, may be subject to an additional 10% IRS tax penalty and trigger interest charges.

While the exemptions may sound fairly straightforward, there are a host of conditions, definitions and calculations to consider. IRS notice 2022-6 explaining the calculation of substantially equal *periodic payments is 17 pages long. It is easy to get tripped up by detailed requirements.*

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