IRC Section 72(t): A Method for Providing Penalty-Free Access to Retirement Funds Prior to Age 59 1/2

by

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Internal Revenue Code §72(t) provides taxpayers a way to withdraw retirement account funds, without penalty, prior to attaining age 59½. The rule applies to IRA accounts, as well as to qualified retirement plans.

Under existing law, funds received from a qualified retirement plan prior to the taxpayer's having attained the age of 59 1/2 are subject to a 10% additional tax or penalty. I.R.C. Section 72(t)(1) and (2). However, the statute provides exceptions to this rule in certain enumerated circumstances. I.R.C. Section 72(t)(2)(A), (B), and (C). The exception we focus upon in this Hot Tip is as follows: withdrawals that constitute “substantially equal periodic payments” allow the taxpayer penalty-free access to funds which would otherwise only be available upon paying the 10% penalty. I.R.C. Section 72(t)(2)(A)(iv). The Internal Revenue Service, in notice 89-25 (attached), has provided three methods for determining what withdrawals may constitute "substantially equal periodic payments" for purposes of the rule:

These are the minimum distribution method, the amortization of account balance method, and the annuity factor method. Each of the methods set forth in notice 89-25 provides a manner of calculating a series of substantially equal periodic payments, based upon the life expectancy of the taxpayer and an assumed interest rate. Assuming the taxpayer withdrew funds from the retirement account in a manner consistent with one of these methods, no penalty for early withdrawal applies.

The statute includes at least one important restriction: Once a plan for withdrawing "substantially equal periodic payments" is initiated, it may not be modified (other than by reason of death or disability) for five calendar years or until the taxpayer attains age 591/2, whichever period is longer. I.R.C. Section72(t)(4)(a). Accordingly, the taxpayer must continue to withdraw the funds precisely according to the plan until the period has elapsed. For example, if the taxpayer begins the withdrawals at age 52, they must continue until age 59 1/2, after which date the withdrawals may be altered as to amount, or even terminated entirely. Alternatively, if the taxpayer begins the withdrawals at age 57, they must continue until five full years have elapsed from the date of the first withdrawal, before they may be altered or terminated. Failure to adhere to this rule will result in the recapture of the amounts previously withdrawn pursuant to the withdrawal plan, the application of the 10% penalty to these amounts, plus interest and other charges.

Private Letter Rulings on the application of Section 72(t) to certain circumstances have permitted the use of cost of living adjustments (COLAS) in the formula for substantially equal periodic payments, as well as withdrawals on a monthly, rather than annual, basis. PLR 950361; PLR 199943050.

The utility of this statute in certain divorce cases is apparent. In cases involving parties in their early to mid-50's, with substantial retirement assets but not enough cash flow to maintain two separate households after dissolution, a plan to withdraw substantially equal periodic payments could be devised to allow the party in need of additional income to have access to the otherwise restricted retirement accounts, penalty-free. The availability of this exception to the 10% penalty rule could be used by the parties in negotiating a settlement to provide a party with the financial cushion necessary to get to an age which would allow penalty-free encroachment on the remaining retirement funds.

The rule may also be used to help defend a maintenance case. For instance, the retirement assets to be awarded a spouse can be so substantial that periodic withdrawals which could be taken prior to age 59 ½ would be sufficient to meet the maintenance claimant's reasonable needs, thereby reducing the amount of maintenance the claimant would otherwise need to receive from the obligor. Where a reasonable rate of return on the retirement assets is imputed based on past performance and present circumstances, the value of the retirement assets may not be diminished, and in fact, it may continue to grow, notwithstanding the periodic withdrawals used for support. When this scenario is presented to the court by a knowledgeable expert, the corresponding argument that the claimant is being asked to consume his or her own equitable share of the marital property to survive, is deflated.

Accordingly, Section 72(t) provides the litigants and the court a creative and practical way to utilize the retirement savings of the parties to enhance the available cash flow for their support, without penalty, and in many circumstances, without diminishing the fund corpus.

A variety of information relating to the use of Section 72(t), including financial calculators, is available on the website www.yyyZ.net.

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