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Plans can change and flexibility may be needed

When it comes to deciding on a retirement age there can be a disconnect between the expectation of retirement age and a retiree's actual retirement date.

A recent retirement confidence survey showed that 64% of current workers expected to retire at age 65 or later.* However, if we look at actual statistical data, the average retirement age is around age 62. The biggest reason for the disconnect is unexpected health problems. Understanding this disconnect can be critical in constructing a comprehensive retirement income plan.

10% withdrawal penalty

If retirement plans change, one challenge pre- or early retirees may face is having to withdraw assets from retirement accounts prior to age 59½. Unless the withdrawal qualifies for an exception, withdrawals prior to 59½ may be subject to an additional 10% premature withdrawal penalty in addition to the withdrawal being subject to ordinary income tax.

72T/Q exception

One of the available exceptions to the 10% penalty is a withdrawal program established using the Substantially Equal Periodic Payment Program (SEPP) 72T/Q exception. Using this payment program allows the taxpayer to avoid the additional 10% penalty on withdrawals prior to age 59½.

64%

of current workers expect to retire at 65 or later[1]

Statistical data reports the average retirement age is around 62.

A withdrawal program established using the 72T/Q exception would need to follow an established withdrawal frequency and duration based on the following:

SEPP must use one of the three approved methods of calculating amount of distribution:

a. **Minimum distribution** — generally smallest amount, will change from year to year.
b. **Annuitization** — fixed amount.
c. **Amortization** — fixed amount, usually largest amount.

SEPP cannot be modified until after the later of age 59½ or 5 years.

a. **Modification may result in a retroactive 10% penalty** on all distributions plus interest and penalties.

Both the **annuitization** and **amortization** methods are calculated using a reasonable rate of return as determined by the IRS.

A withdrawal program that qualifies under the SEPP 72T/Q exception would avoid the 10% premature tax penalty applied to premature withdrawals prior to age 59½ from most qualified accounts and nonqualified annuities.

1 Greenwald and associates 2021 retirement confidence survey.

The IRS has recently provided some relief for those forced to retire earlier than maybe previously anticipated

Recently the IRS published notice 2022-6 and updated the way interest rates are determined when calculating a SEPP program under IRC section 72T/Q. This update may allow for a larger withdrawal than previously allowed under older calculation methods.

Prior to 2022-6, the maximum interest rate that could be used in calculating a 72T/Q payment was a rate up to, but not exceeding, 120% of the federal midterm rate. As a result of the current low interest rate environment, even maxing out a rate at 120% of the federal midterm rate may not have allowed for significant 72T/Q withdrawals. Moving forward, Notice 2022-6 may provide some relief for individuals looking for higher withdrawals prior to age 59½. The relief comes in the ability to use a more generous rate than the current maximum of 120% of the federal midterm rate when calculating an early withdrawal program. Notice 2022-6 now allows for any interest rate that is not more than the greater of (i) 5% or (ii) 120% of the federal midterm rate.

There are a few important points to remember regarding the new rules.

The first is the interest rate used in the calculation ***does not equate*** with a withdrawal percentage. For example, on a $500,000 account for a 55-year-old, the annual distribution for the 72 T/Q using a 5% interest rate in the SEPP distribution calculation, the withdrawal amount would be $32,720 (amortization method). That equates to a withdrawal percentage slightly over 6%. This leads to the second important point in the notice. The language of the notice allows for a use of a rate not more than the greater of (i) 5% or (ii) 120% of the federal midterm rate. The important part of that phrase is the ***not more than***. SEPP program calculations have always been allowed to use a rate less than the stated maximum when calculating an early withdrawal payment. This flexibility may allow an individual to customize a withdrawal strategy that meets their specific needs rather than just withdrawing the maximum allowable under the program. For example, on the same $500,000 account for a 55-year-old, a 5% withdrawal percentage of $25,000 would require use of 72T/Q calculation rate of approximately 2.8% — higher than the fed midterm rate but lesser than the allowable 5% maximum (annuitized method).

The SEPP in action

Meet Ray

- Age 55
- $500,000 account balnace

Calculation method	Life expectancy	Amortized over life	Annuitized over life
Interest rate 2.8%	$16,892	$25,070	$24,968

When engaging in a 72T/Q program, it's important to remember the payments under the program must remain consistent throughout the program duration lasting for the longer of 5 years or until reaching age 59½. If the program is modified prior to completion, there may be a retroactive penalty on all previous income received.

Annuity benefits

This new flexibility with 72T/Q may also be combined with a guaranteed benefit strategy using a variable annuity to allow for customization of an early retirement program for the early retiree. Combining the SEPP with a guaranteed income strategy may allow the early retiree a bridge into the later years of retirement and possibly maximize all sources of retirement income.

To learn more, contact your financial professional or visit equitable.com.

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