TAX YEAR 2021

Early Retirement Distributions — SEPP

ACCUSURE TAX

HELPING SMALL BUSINESS AND FAMILIES MANAGE THEIR FINANCIAL AND INSURANCE AFFAIRS

Early Retirement Distributions

You may choose, or be forced into choosing, early retirement. Retirement before age 59½ may create income challenges. You are not yet eligible to receive retirement benefits from Social Security. You may or may not have a monthly pension to generate income.

In many situations, you will need to generate income from your assets. Often, most of your assets are in a retirement plan through a 401(k) plan at your employer or in an individual retirement arrangement (IRA). Withdrawals of earnings and pre-tax contributions are subject to ordinary income tax. In addition, you may be subject to the 10% early withdrawal penalty tax on distributions taken before you reach age 59½.

Tax Summary

- Withdrawals of earnings and pre-tax contributions from an IRA are subject to ordinary income tax.
- Unless an exception applies, taxable withdrawals from an IRA prior to age 59½ are subject to a 10% early withdrawal penalty.
- If you take a series of substantially equal periodic payments from an IRA, you are not subject to the 10% additional tax.

Tax Planning Strategy

One strategy to generate income from retirement accounts if you are under age 59½ is to take periodic distributions from those accounts. If structured properly, the 10% additional tax will not be assessed on the distributions. You can take distributions from various retirement accounts such as 401(k) plans, 403(b) plans, and IRAs.

Substantially Equal Periodic Payments (SEPP)

The Internal Revenue Code allows you to take withdrawals from retirement accounts without incurring the 10% penalty. To do so, very specific rules need to be followed.

- The payments made to you from the IRA are based on one of three calculation methods.
- The payments must be made to you at least annually during the payment years. Payments can be made more frequently, such as monthly, but the total for each year during the SEPP period must meet the payment calculation result for the year or years during the SEPP.
- Payments must be made for a period of at least five years or until you reach age 59½, whichever is later.

Example: *Fred, age 52, establishes a SEPP from his IRA. He must continue to take withdrawals until he reaches age 59½. If he discontinues or changes his SEPP withdrawals at any time before he reaches age 59½, unless an exception applies, the current year withdrawal is subject to the additional 10% tax. In addition, the SEPP withdrawals for previous years are retroactively subject to the additional 10% tax.*

If, however, Fred begins SEPP withdrawals at age 58, he must continue the withdrawals to age 63 to comply with the 5-year withdrawal requirement.

Calculation Method

Payments are considered to be substantially equal periodic payments if they are made in accordance with one of the three calculation methods allowed.

1) **Required minimum distribution method.** Under this method, the account balance, the number from the life expectancy table, and the resulting annual payment amount is re-determined each year.
2) **Fixed amortization method.** The annual payment for each year is determined by amortizing in level amounts the account balance over a specified number of years

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determined using a life expectancy table and a chosen interest rate. Under this method, the annual payment is determined once for the first distribution year and the annual payment is the same in each succeeding year.

3) **Fixed annuitization method.** The annual payment for each year is determined by dividing the account balance by an annuity factor that is the present value of an annuity of $1 per year beginning at the taxpayer's age and continuing for the life of the taxpayer. The annuity factor is derived from a mortality table and a chosen interest rate. Under this method, the annual payment is determined once for the first distribution year and the annual payment is the same amount in each succeeding year.

One-Time Change to Required Amount

If you begin distributions in a year using either the amortization method or the annuitization method, you may in any subsequent year switch to the required minimum distribution method to determine the payment for the year of the switch and all subsequent years. The change in method will not be treated as a modification. Once a change is made, the required minimum distribution method must be followed in all subsequent years until the required number of years under the plan have been met.

Changes to Account Balance

No other contributions or distributions can be taken from the account being distributed from during the SEPP period. This includes nontaxable transfers in or out of the account.

Example: *Susan establishes a SEPP distribution from her IRA. Two years later, at age 53, she takes on a new job and wants to make contributions to an IRA with her newly earned income. Susan cannot contribute to the IRA that is making her SEPP distribution. Susan can establish a new, separate IRA account that she can make contributions to.*

Depletion of Account Value

If, as a result of following an accepted method of determining SEPP withdrawals, your IRA assets are exhausted, you will not be subject to the additional income tax of 10%. The resulting cessation of payments will not be treated as a modification of the series of payments.

Example: *Dick established a SEPP distribution plan at age 54 that required him to take a distribution amount of $25,000 each year. He invested aggressively in his SEPP account and, due to distributions and declines in the stock market, the value of his account was down to $15,000 when Dick took his distribution at age 58. Because the account has been depleted, none of the amounts distributed through the SEPP plan in prior years are subject to the 10% additional tax. In addition, the $15,000 distribution at age 58 is not subject to 10% additional tax. Also, because the account has been depleted, he will face no tax consequences for not being able to take a distribution at age 59.*

Possible Risks

- The rules for distributions using the Internal Revenue Code provide very little flexibility. Once the distribution begins, you need to exert extreme caution in making any changes to the distribution amount and frequency.
- You need to document the calculations used to determine the distribution, as well as any change in distribution. Tax courts have consistently assessed the 10% additional tax for taxpayers who could not substantiate the distributions were, in fact, based on SEPP calculations.

Contact Us

There are many events that occur during the year that can affect your tax situation. Preparation of your tax return involves summarizing transactions and events that occurred during the prior year. In most situations, treatment is firmly established at the time the transaction occurs. However, negative tax effects can be avoided by proper planning. Please contact us in advance if you have questions about the tax effects of a transaction or event, including the following:

- Pension or IRA distributions.
- Significant change in income or deductions.
- Job change.
- Marriage.
- Attainment of age 59½ or 72.
- Sale or purchase of a business.
- Sale or purchase of a residence or other real estate.
- Retirement.
- Notice from IRS or other revenue department.
- Divorce or separation.
- Self-employment.
- Charitable contributions of property in excess of $5,000.