

Avoid the Penalty on Early IRA Withdrawals

Arranging “Substantially Equal Periodic Payments”

Where can you turn if you need cash in a hurry? One possible source is your IRA. You generally have the flexibility to tap into this type of account, but your IRA is meant to be a retirement savings vehicle. So this option should be used only when circumstances dictate.

Consider the Tax Implications

IRA distributions are subject to tax at ordinary income tax rates. Plus, you generally will have to pay a 10% penalty tax if you are younger than 59.5. You can avoid the penalty if you arrange to receive “substantially equal periodic payments” (SEPPs) from the IRA.

Background

The normal penalty tax for early IRA withdrawals does not apply to SEPPs paid for the longer of five years or the time until you reach age 59.5. The payments are based on your life expectancy (or the joint life expectancy of yourself and a designated beneficiary).

The IRS allows three basic methods for receiving SEPPs. If you substantially modify the payment methods before reaching age 59.5 (or five years, if that is later) the penalty tax still applies. The three IRS-approved methods are:

Required Minimum Distribution (RMD) Method – Under this method, the annual payment is determined by dividing the account balance by your applicable life expectancy taken from IRS tables for that year. Those numbers change annually, resulting in a slightly different payment amount each year.

Fixed Amortization Method – With this method, the annual payment is determined by amortizing the account balance over a period of years using the applicable life-expectancy table and assumed interest rate. The annual payment remains the same each year.

Fixed Annuitization Method – The annual payment is determined by dividing the account balance by an annuity factor derived from a mortality table with an assumed interest rate. As with the second method, the amount stays the same year to year.

The RMD method is the simplest option and tends to provide the smallest annual payout, while the other two methods generally provide larger payouts.

Note that the exception for SEPPs is applied separately to each IRA. If you maintain several IRAs, you can arrange to receive annual payments from only one of them.

Reminder

It is generally not advisable to invade your IRA without good reason. Use this exception to the early withdrawal penalty with discretion. ■



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