Avoiding a Penalty on Early Distributions From Qualified Plans and IRAs

A 10% penalty generally applies if a taxpayer receives early distributions from a qualified plan or IRA, but there are exceptions. This article focuses on the exception for distributions that are substantially equal periodic payments.

BRUCE D. STEINER, ATTORNEY

Distributions from qualified retirement plans[1] before age 59½ are generally subject to a 10% penalty.[2] There are, however, several exceptions to the imposition of this penalty:

- Distributions to a deceased employee's estate or beneficiaries.[3]
- Distributions attributable to the employee's being disabled.[4]
- Distributions that are part of a series of substantially equal periodic payments, made annually or more frequently, over the life or life expectancy of the employee or of the employee and a designated beneficiary.[5]
- Distributions from a qualified plan (but not an IRA) after separation from service after attaining age 55.[6]
- Dividends paid on certain employer securities.[7]
- Certain distributions for medical expenses.[8]
- Distributions from a qualified plan (but not an IRA) to an alternate payee pursuant to a qualified domestic relations order ("QDRO").[9]
- Certain distributions to unemployed individuals for health insurance premiums.[10]

Despite the substantial benefits of tax deferral offered by retirement plans, there are situations when taxpayers may need to receive distributions before age 59½. For example, a taxpayer may take early retirement or suffer a financial hardship. Or a surviving spouse who rolled over the deceased spouse's retirement benefits into her own IRA may wish to take distributions before age 59½.

Even if there is no hardship, a taxpayer may want to take early distributions for estate planning purposes. For instance, a taxpayer with substantial retirement benefits may desire to make annual exclusion or other gifts, but may not have other available assets. Or a taxpayer may wish to establish a life insurance trust, and need to withdraw amounts from his or her IRA benefits to pay the premiums. In each of these cases, the ability to avoid the penalty for early distributions is extremely valuable. This article analyzes the exception for substantially equal periodic payments.

The Internal Revenue Code provides no guidance as to when payments will qualify as substantially equal periodic payments for purposes of avoiding the 10% penalty. However, the IRS has issued guidance as well as numerous private letter rulings approving various ways of structuring the payments.

In Notice 89-25,[11] the Service approved three methods of structuring a series of substantially equal periodic payments. These methods are the minimum required distribution ("MRD") method, the amortization method, and the annuity factor method. These

BRUCE D. STEINER, a member of the New York, New Jersey and Florida Bars, is tax counsel to the law firm of Kleinberg, Kaplan, Wolff & Cohen, P.C., with offices in New York City and Hackensack, New Jersey. He is a frequent author and lecturer on taxation and estate planning, and has previously written for ESTATE PLANNING.
Copyright © 1999, Bruce D. Steiner.

methods are not exclusive, however. It is not difficult to structure payments so that they will qualify as substantially equal periodic payments, but the penalty for failing to qualify is severe.

In this regard, the Joint Committee staff explanation of TRA '86 states that payments may vary on account of certain cost of living adjustments.[12]

No aggregation required

A taxpayer with more than one IRA can take substantially equal periodic payments with respect to one IRA without regard to his other IRAs.[13] Accordingly, a taxpayer may wish to use the method that results in the largest possible distributions. If such distributions would exceed the amount desired, the taxpayer can divide the IRA into two separate IRAs and take distributions with respect to one IRA, thus preserving the flexibility to increase his distributions in the future by taking distributions from the other IRA (or by dividing the other IRA into two separate IRAs, and taking distributions from one of them).

The Service specifically approved this approach in Ltr. Rul. 9812038. In that ruling, the taxpayer was withdrawing distributions from one of three IRAs. The taxpayer transferred a portion of one of the other IRAs to a fourth IRA, and then began taking distributions from the fourth IRA.

Minimum required distribution method

In Notice 89-25, the Service said that the payments can be determined using a method that would be acceptable for purposes of calculating the minimum required distributions under Section 401(a)(9). For this purpose, the payments may be determined based on the life expectancy of the employee or the joint and survivor life expectancy of the employee and his designated beneficiary.

For example, suppose Michele, age 50, has a $1 million IRA. Her designated beneficiary is David, also age 50. Because life expectancy at age 50 is 33.1 years,[14] Michele can take 1/33.1 of her IRA ($30,211) in the first year, 1/32.1 of her IRA in the second year, and so on, or slightly less in the second and succeeding years if she recalculates her life expectancy.[15]

Alternatively, because Michele and David's joint and survivor life expectancy is 39.2 years,[16] Michele can take 1/39.2 of her IRA ($25,510) in the first year, 1/38.2 of her IRA in the second year, and so on, or slightly less in the second and succeeding years if she recalculates her life expectancy (or, if David is her spouse, if she recalculates his life expectancy or both life expectancies, although if she recalculates his life expectancy the payments will be based on her life expectancy alone if he dies). Of course, since the use of a beneficiary's life expectancy reduces the annual distributions, a taxpayer seeking to maximize distributions would generally take distributions based on his or her single life expectancy.

The MRD method initially produces smaller distributions than the other methods. For example, if Michele's IRA earns an 8% return and she uses her single life expectancy, her IRA will be $1,049,789 ($1 million plus $80,000 investment return less $30,211) at the end of the first year, so her distribution in the second year will be $32,704 (1/32.1 of $1,049,789). However, her distributions will increase more quickly under this method, due to her increase in age and the investment return within her IRA.

The MRD method does not require an interest rate to be selected in advance, so there is no issue as to what is a reasonable interest rate. Taxpayers can thus calculate the amount of their distributions under the MRD method with certainty. On the other hand, because this method produces smaller initial distributions than the other methods, it is generally less favorable. Accordingly, there are only a few private rulings approving this method, although it was approved in Ltr. Ruls. 9121047, 9104020, and 9049044.

Amortization method

Notice 89-25 provides that payments will be treated as substantially equal periodic payments if the amount to be distributed annually is determined by amortizing the taxpayer's retirement account balance over the taxpayer's life expectancy (or the joint and survivor life expectancies of the taxpayer and beneficiary) at an interest rate that does not exceed a reasonable interest rate on the date payments commence.

Because the amortization method takes future earnings into account by means of the assumed

---

1 Sections 72(t)(1) and 4974(c).
2 Sections 72(t)(1) and 72(t)(2)(A)(i).
3 Section 72(t)(2)(A)(ii).
4 Section 72(t)(2)(A)(iii).
5 Section 72(t)(2)(A)(iv).
6 Sections 72(t)(2)(A)(v) and 72(t)(3)(A).
7 Sections 72(t)(2)(A)(vi) and 404(k).
8 Section 72(t)(2)(B).
9 Sections 72(t)(2)(C), 72(t)(3)(A), and 414(p)(1).
10 Section 72(t)(2)(D).
11 1989-1 CB 662.
12 Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 717.
13 Ltr. Ruls. 9812038, 9801050, 9747045, and 9050030.
14 Reg. 1.72-9, Table V.
15 Section 401(a)(9)(D).
16 Reg. 1.72-9, Table VI.

interest rate, the payments will initially be substantially higher than under the MRD method. For example, if Michele amortizes her $1 million IRA over 33.1 years, she can take $70,203 per year at a 6% interest rate, or $86,795 per year at an 8% interest rate. Alternatively, if she uses her and David's joint and survivor life expectancy of 39.2 years, she can take $66,805 per year at a 6% interest rate, or $84,118 per year at an 8% interest rate.

In this regard, the IRS has approved the use of interest rates equal to 120% of the long-term applicable Federal rate ("AFR"),[17] 120% of the mid-term AFR,[18] 100% of the long-term AFR,[19] the Section 7520 rate (120% of the mid-term AFR, rounded to the nearest 0.2%),[20] 5%,[21] 5.95%,[22] 6%,[23] 7%,[24] 7.17%,[25] 7.4496%,[26] 7.492%,[27] 8%,[28] 8.2455%,[29] 8.5%,[30] 8.8%,[31] 9%,[32] 10%,[33] and 10.6%.[34] Some of the letter rulings approving some of the higher interest rates were issued when interest rates were relatively high, so they may not be indicative of what the Service might approve when interest rates are lower. For example, the Section 7520 rate ranged from 8.6% to 11.6% during the period 1989-91, but has ranged from 5.4% to 5.6% during the period November 1998 to February 1999.

In several cases, taxpayers offered justifications for the interest rates they selected. For example, in Ltr. Rul. 9223049, the interest rate of 9% was less than the average rate of return over the preceding five years for the fund in which the taxpayer's plan assets were invested. Similarly, in Ltr. Rul. 9040044, the taxpayer asserted that the interest rate of 10% was a reasonable rate of return based on the performance record of the management company with which the IRA assets were to be invested. Given both recent and historical investment returns, an interest rate of 9% or 10% might be reasonable, at least for a taxpayer investing substantially in equities, although the only way to be certain is to obtain a private ruling.

In addition to providing for an interest rate, the Service has approved the use of cost of living adjustments in connection with the amortization method. In Ltr. Rul. 9747045, the Service approved a 3% cost of living adjustment (in other words, each year's payment would be 3% greater than the previous year's payment) together with an interest rate equal to 120% of the long-term AFR. In Ltr. Rul. 9536031, a 3% cost of living adjustment was approved together with a 5.95% interest rate. In Ltr. Rul. 9047043, a cost of living adjustment equal to the annual increase in the Section 415 defined benefit limitation was approved together with an 8% interest rate. To the extent that nominal investment returns take inflation into account, the reasonableness of the interest rate and the reasonableness of the cost of living adjustment would be interdependent.

Annuity method

The third method described in Notice 89-25 is the annuity method. This method is similar to the amortization method, except that it uses different life expectancy tables. The effect of this is to permit slightly higher payments.

More specifically, Notice 89-25 states that payments will be treated as substantially equal periodic payments if the amount to be distributed each year is determined by dividing the account balance by an annuity factor. The annuity factor is derived from using a reasonable mortality table and an interest rate that does not exceed a reasonable interest rate on the date the payments commence. The Notice contains an example that uses the UP-1984 mortality table and an 8% interest rate. Based on the assumptions in this example, an individual age 50 with a $100,000 account balance would receive annual distributions of $9,002.

In addition to the UP-1984 table, which the Service approved in several rulings,[35] the Service has approved the use of Table 80CNSMT[36] and the 1983 IAM Male Mortality Table.[37] Since Notice 89-25 was issued, the Service has published a new mortality table, Table 90CM, which has generally replaced Table 80CNSMT, effective June 1999. The UP-1984, 80CNSMT, and 90CM tables, as well as the Service's annuity tables used in Reg. 1.72 are available in Brentmark Software's Pension Distributions Calculator, Pension and Roth Ana-

17 Ltr. Ruls. 9812038, 9747045, and 9310054.
18 Ltr. Rul. 9747039.
19 Ltr. Ruls. 9615042, 9324036, 9241063, 9240042, 9152041, 9050030, and 9010075.
20 Ltr. Rul. 9338048.
21 Ltr. Rul. 9505022.
22 Ltr. Rul. 9536031.
23 Ltr. Rul. 9604026.
24 Ltr. Ruls. 9801050, 9705033, 9545018, 9541034, and 9401040.
25 Ltr. Rul. 9126060.
26 Ltr. Rul. 9253053.
27 Ltr. Rul. 9416036.
28 Ltr. Ruls. 9341031, 9312035, 9246027, 9243054, 9231048, 9217048, 9109052, 9047043, and 9013008.
29 Ltr. Rul. 9830042.
30 Ltr. Rul. 9337023.
31 Ltr. Rul. 9601052.
32 Ltr. Ruls. 9223049 and 9047076.
33 Ltr. Rul. 9040044.
34 Ltr. Rul. 9050046.
35 Ltr. Ruls. 9816028, 9723035, 9531039, 9525062, and 9123062.
36 Ltr. Rul. 9824047.
37 Ltr. Rul. 9021058.

EXHIBIT 1
Effect of Different Tables

	Reg. 1.72	Table 80 CNSMT	Table UP-1984	Table 90CM
Taxpayer only, 6% interest	$73,353	$79,964	$75,637	$78,433
Taxpayer only, 8% interest	$90,632	$97,201	$90,017	$95,680
Taxpayer and beneficiary, 6% interest	$67,684	$70,914	n/a	$70,101
Taxpayer and beneficiary, 8% interest	$85,067	$87,935	n/a	$87,209

lyzer or Estate Planning Tools[38] or in Steve Leimberg's Number Cruncher software.[39] The effect of the different tables is illustrated in Exhibit 1; each case in the Exhibit is based on a taxpayer age 50 with a $1 million IRA, and a beneficiary who is also age 50.

The Service has approved interest rates of 5.6%,[40] 6%,[41] 7.5%,[42] 8%,[43] 8.5%,[44] and the mid-term AFR in connection with the annuity method.[45] A 3% cost of living adjustment was approved in Ltr. Ruls. 9816028 and 9723035, in each case with a 7.5% interest rate. In Ltr. Ruls. 9723035 and 9525062, payments were calculated with respect to one or more—but not all—of the taxpayer's IRAs.

While Notice 89-25 specifically permits payments to be calculated under the MRD or the amortization methods using either the taxpayer's life expectancy or the joint and survivor life expectancies of the taxpayer and his beneficiary, the Notice does not refer to the use of a beneficiary's life expectancy with respect to the annuity method. In Ltr. Rul. 9824047, however, the Service approved the use of an annuity factor for the joint and survivor life expectancy of the taxpayer and her oldest son, treating the son as if he were ten years younger than the taxpayer, consistent with the MDIB rules. Of course, the use of a beneficiary reduces the amount of the annual distributions.

Combination of MRD and amortization methods

In Ltr. Ruls. 9241063 and 9008073, the Service approved a method combining the features of both the MRD and the amortization methods to produce higher payments in succeeding years. In each of these rulings, the account balance was amortized over the taxpayer's life expectancy (Ltr. Rul. 9241063), or over the joint and survivor life expectancies of the taxpayer and his wife (Ltr. Rul. 9008073), at an interest rate equal to the long-term AFR. In each case, though, the applicable life expectancy was reduced by one year for each year subsequent to the initial year. This approach results in higher payments after the first year than if either the MRD or the amortization method were used alone.

In Ltr. Rul. 9008073, the Service acknowledged that this method was not one of the three methods specified in Notice 89-25. But the Service found that "the distribution methods described in Notice 89-25 are intended to serve as examples of substantially equal periodic payments and do not represent the only distribution methods which will satisfy section 72(t)(2)(A)(iv)." Accordingly, the Service ruled that the proposed method of distribution was "consistent with the guidelines set forth in Notice 89-25."

Ltr. Rul. 9241063 is also unusual because in determining the payment to be made each January 1, the interest rate is recalculated, using the long-term AFR in effect during the previous December.

Additional issues

Subsequent changes in method not permitted. Under Section 72(t)(4), once the taxpayer begins to take distributions, if the series of periodic payments is modified within five years from the first payment—or before age 59½, if later—the 10% penalty is effectively imposed retroactively. This is accomplished by increasing the tax in the year of the modification by the penalty that would have been imposed but for the exception for substantially equal periodic payments.

This statutory provision can be illustrated by the Tax Court decision in *Arnold*.[46] Mr. Arnold began taking substantially equal periodic payments from his IRA in 1989 when he was age 55. He took $44,000 in December 1989 and in January 1990 through January 1993. Then, in November 1993, after reaching age 59½, he took an additional $6,776. The Service

[38] Brentmark Software, One Purlieu Pl., Winter Park, FL 32792, tel. (800) 879-6665.
[39] Leimberg & LeClair, Inc., P.O. Box 1332, Bryn Mawr, PA 19010, tel. (610) 527-5216.
[40] Ltr. Rul. 9525062.
[41] Ltr. Rul. 9824047.
[42] Ltr. Ruls. 9816028 and 9723035.
[43] Ltr. Rul. 9123062.
[44] Ltr. Rul. 9021058.
[45] Ltr. Rul. 9531039.
[46] 111 TC 250 (1998).

Practice Ideas

If the amortization or annuity method is used to calculate distributions, consider obtaining a private letter ruling as to the reasonableness of the desired interest rate, especially if the interest rate is not determined with reference to the AFR or the Section 7520 rate.

contended that this impermissibly modified the series of substantially equal periodic payments within the five-year period beginning on the date of the first distribution. As a result, the Service imposed the 10% recapture tax, plus interest, on all distributions the taxpayer received before age 59½.

Mr. Arnold took the position that the series of substantially equal periodic payments was completed with the fifth distribution in January 1993. He also argued that the $6,776 distribution in November 1993 represented a cost of living adjustment and that the additional distribution was on account of hardship. However, because (1) the distribution method cannot be modified for a full five years,[47] (2) the taxpayer failed to prove that the November 1993 distribution was a cost of living adjustment, and (3) there is no exception under Section 72(t) for hardship,[48] the Tax Court in *Arnold* held for the Service. Consequently, the taxpayer was liable for an additional $21,221 of tax as a result of his $6,776 distribution in November 1993.

Similarly, in Ltr. Rul. 9821056, the Service refused to permit a taxpayer to change the method of calculating the payments so as to increase the distributions by 19.7%. After taking distributions for five years under the amortization method (but before reaching age 59½), the taxpayer sought to increase the interest rate, use a more recent account balance, and use a current life expectancy. The Service refused to permit such a modification without penalty. Likewise in Ltr. Rul. 199943050, the Service refused to permit the taxpayer to change the method of payments to include a cost of living adjustment which was not in the original payment method.

Plan terminations and rollovers. A taxpayer who is receiving substantially equal periodic payments from a qualified plan, and who receives a lump-sum distribution upon the termination of the plan, can preserve the exemption from the 10% penalty by rolling the proceeds over into an IRA and taking distributions from the IRA in the same manner as the distributions from the qualified plan.[49] In contrast, a taxpayer receiving substantially equal periodic payments from her IRA becomes subject to the penalty if she rolls her IRA back into a qualified plan and ends her periodic payments.[50]

Conclusion

The exception from the 10% penalty for distributions before age 59½ for substantially equal periodic payments can be useful for younger taxpayers in various situations. A taxpayer who is satisfied with the amount that he can withdraw using the MRD method can calculate his distributions under this method with certainty. Taxpayers seeking to take larger distributions can use the amortization or the annuity method.

However, a taxpayer using the amortization or annuity method may wish to obtain a private letter ruling as to the reasonableness of the desired interest rate, especially if the interest rate is not determined with reference to the AFR or the Section 7520 rate. Similarly, a taxpayer may wish to obtain a letter ruling approving a variable interest rate, a cost of living adjustment, a hybrid method, or any method other than the ones set forth in Notice 89-25. Although the letter rulings discussed in this article are not binding on the Service as precedent, they can be useful to taxpayers and their advisors in structuring methods of taking distributions and in preparing their own ruling requests. ■

---

47 Section 72(t)(4)(A)(ii)(I); H.R. Rep't No. 99-841, 99th Cong., 2d Sess., at II-457.

48 Duffy, TCM 1996-556; Pulliam, TCM 1996-354.

49 Ltr. Ruls. 9221052 and 9103046.

50 Ltr. Rul. 9818055.