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LAGOS WEALTH ADVISORS
BUILDING, PROTECTING AND PERPETUATING FAMILY WEALTH

# ADVISOR'S BULLETIN

## WHAT'S IN THIS MONTH'S NEWSLETTER

**What Every Financial Professional Needs to Know About Substantially Equal Payments Under Section 72(t)**

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The Advisor's Bulletin is provided by Lagos Wealth Advisors and Lagos Financial & Insurance Services, Inc. It is intended to serve as a resource for the advisors which we are associated with. Recent developments in estate, business, and insurance planning are outlined for your reference. Should you wish to receive additional information related to financial planning, estate planning, insurance planning, or investment management, please do

## A MESSAGE FROM MICHAEL W. LAGOS, CFP®

Dear Strategic Advisor:
Our clients lean on us for advice regarding how to maximize retirement income. We are often called on to provide information about pensions and Social Security retirement payments. We can provide annuities and other financial products to create retirement income.

For a person seeking to keep the most income during retirement, income taxes should be minimized. Financial professionals have a variety of products with special tax features at their disposal that feature

- tax-deferred growth,
- tax-free income, and
- relatively low capital-gains rates.

Some of our clients lean on their retirement income sources sooner than others. Among those clients, some face the possibility that their retirement income sources may be unavailable. Others who will retire early also face additional taxes that will make the economics of early retirement difficult.

One such early tax penalty is the 10 percent additional tax that applies to the taxable portion of qualified plan distributions, IRA distributions, and nonqualified deferred annuity (NQDA) distributions. The Tax Code provides that distributions to those younger than 59 ½ generally are subject to the 10 percent penalty tax on the taxable portion of distributions.

Application of the additional tax doesn't feel fair if the taxpayer is legitimately retiring early. Fortunately, many in that category qualify for a special category of penalty tax relief. If a taxpayer takes the kind of *substantially equal payments for life* (SEPL) described in Section 72(t) from a qualified plan or IRA, the taxpayer can avoid the penalty. A taxpayer may also opt for SEPL distributions under Code Section 72(q) for NQDAs.

Advisors need to educate their clients about SEPL and help them decide when SEPL distributions are the right way to avoid the penalty tax on qualified-plan, IRA, or NQDA distributions.

In this issue, we'll discuss the penalty tax, the requirements to meet the SEPL test, and the consequences of failing to conform to its requirements. We originally wrote about SEPL distributions in 2013. This is an update to include information that has changed since then.

Please feel free to contact me to discuss further.

Regards,
Michael W. Lagos, CFP®

# What Every Financial Professional Needs to Know About Substantially Equal Payments Under Section 72(t)

## THE PENALTY TAX AND ITS EXCEPTIONS

Code Section 72 is the source of both the penalty tax on early distributions and its exceptions.

### *Section 72(t) for IRA and Qualified-Plan Distributions*

Code Section 72(t) imposes the extra tax on IRA and qualified-plan distributions:

> **(t) 10-percent additional tax on early distributions from qualified retirement plans**
>
> > **(1) Imposition of additional tax**
> > If any taxpayer receives any amount from a qualified retirement plan . . . the taxpayer's tax under this chapter for the taxable year in which such amount is received shall be increased by an amount equal to 10 percent of the portion of such amount which is includible in gross income.

### *General Exceptions to the Penalty Tax*

Code Section 72(t) also lists the kinds of distributions that are exempt from the tax. Here are the most common exceptions:

- Death of the participant
- Disability of the participant
- Part of a series of substantially equal payments based on life expectancy

Note that hardship withdrawals made from a Section 401(k) or a Section 403(b) plan are not automatically exempt from the penalty tax. Financial need is not an exception to the 10 percent penalty tax.

The IRS has created a helpful chart that lists all the exceptions to the penalty tax that are available to IRAs or qualified retirement accounts.

### *The SEPL Exception*

Distributions that are part of a series of substantially equal periodic payments made for the life (or life expectancy) of the employee or the joint lives (or joint-life expectancies) of the employee and his designated beneficiary are exempt from the penalty tax. See Revenue Code Sec.72(t)(2)(A)(iv).

The IRS issued Revenue Ruling 2002-62 more than 20 years ago. It sets forth most of the rules governing this exception to the 10 percent penalty.

The ruling sets out three safe harbor methods for determining payments under a series of substantially equal periodic payments:

1. the required minimum distribution (RMD) method,
2. the fixed amortization method, and
3. the fixed annuitization method.

Each of the three methods requires use of a **life expectancy table**. The regulations provide that the taxpayer can elect

- the Uniform Lifetime Table,
- the single life expectancy table, or
- the joint and last survivor table.

Once begun, Section 72(t) says the payments must generally continue for the longer of five years or to the taxpayer's age 59 ½.

The Service has conceded that there may be other ways for a taxpayer to satisfy the requirements of Sections 72 (t) or 72(q) without relying on one of the safe harbor methods. However, those who want to be sure that their SEPL arrangements will pass muster should likely rely on one of the approved strategies.

THE RMD METHOD

Using the RMD method to calculate SEPL payments is similar to calculating RMDs from a qualified plan for a taxpayer older than 73. Here's how Revenue Ruling 2002-62 describes the RMD method:

> The annual payment for each year is determined by dividing the account balance for that year by the number from the chosen life expectancy table for that year. Under this method, the account balance, the number from the chosen life expectancy table and the resulting annual payments are redetermined for each year.

The RMD method allows the use of any one of the three life expectancy tables in its calculation, making it possible to dial in certain payment levels depending on the table used. For example, a taxpayer wanting relatively high payments to be calculated under the RMD method should use the single life expectancy table, which has the *lowest* life expectancy factors.

Here's an example of how the RMD method might work. Say that Morris, who turned 50 this year, has a $500,000 balance in his IRA. Morris's wife Sarah turned 45 this year and is the beneficiary of his IRA account.

Morris decides to begin SEPL payments from the account. To calculate the proper distribution using the RMD method, he must first determine the correct factor from the life expectancy tables. The factors from the most recent life expectancy tables are

- 48.5 from the uniform lifetime table
- 36.2 from the single life table
- 45.1 from the joint and last survivor life table

In our experience, most taxpayers seeking to start SEPL distributions want to generate the highest possible conforming income stream. For Morris, that would mean using the factor from the single life table to calculate the amount of the distributions. If Morris chooses to distribute according to the single life table factor, his annual distribution amount would be $13,812.

The regulations provide that once a table is chosen, it must be used for all RMD-style distributions. Furthermore, the regulations say that the taxpayer must be consistent with regard to how the IRA's cash value account for the year in question is determined.

Say that after the first distribution is made, the cash value of Morris's IRA in 2025 on the same date as it was used for the 2024 distribution is $495,000. According to the single life table, the distribution factor for a 51-year-old—Morris's birthday age in 2025—is 35.3. The annual SEPL distribution for Morris in 2025 will be $14,023.

THE FIXED AMORTIZATION METHOD

According to Revenue Ruling 2002-62, under the amortization method,

> the annual payment for each year is determined by amortizing in level amounts the account balance over a specified number of years determined using the chosen life expectancy table and the chosen interest rate.

The Revenue Ruling also says,

> The interest rate that may be used is any interest rate that is not more than 120 percent of the federal mid-term rate (determined in accordance with § 1274(d) for either of the two months immediately preceding the month in which the distribution begins).

The more recent Notice updated the life expectancy table factors effective beginning in 2023 and changed the allowable interest rate to "any interest rate that is not more than the greater of (i) 5% or (ii) 120% of the federal mid-term rate."

If distributions begin in February 2024, the interest rate that may be used may not exceed 5.2 percent (February's 120 percent of federal mid-term rate).

Using the example of 50-year-old Morris and his $500,000 account balance, the SEPL amortization method calculation would amortize the $500,000 account over 36.2 years if the single life table is used. If Morris uses the 5.2 percent interest rate for the amortization, the annual SEPL distribution would be $30,938.

Unlike distributions taken under the RMD method, the distributions calculated under the amortization and annuitization methods are level for the SEPL duration.

THE FIXED ANNUITIZATION METHOD

Revenue Ruling 2002-62 says that for the 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 (or the joint lives of the individual and beneficiary). The annuity factor is derived using the mortality table in Appendix B and using the chosen interest rate.

The mortality table described in the Revenue Ruling is the same one used to calculate the mortality durations in the single life table for RMD calculations. The interest rate may not be greater than 5 percent or 120 percent of the AFMR for the prior two months from the date distributions start, whichever is greater.

For 50-year-old Morris and his $500,000 IRA, the annuitization method yields an annual payment of $30,377—slightly less than that calculated under the amortization method.

*Five-Year Rule*

If a taxpayer elects to receive SEPL payments to avoid the 10 percent penalty, the taxpayer may not modify the series of distributions for at least five years, or, if later, the taxpayer reaches age 59 ½. For example, if a 40-year-old taxpayer begins receiving SEPL distributions, she must continue the program until she reaches actual age 59 ½. Additionally, she generally will not be able to alter the series of distributions for the 19 ½ years before she reaches 59 ½.

On the other hand, if she begins receiving such distributions at age 58, she must continue the

program until she reaches age 63 because the five years would pass after she reaches age 59 ½.

After the required five years or more have passed, the taxpayer may change the distribution method. This means the taxpayer may distribute everything or stop distributions completely—or anything in between.

If the taxpayer modifies the series of payments early, he or she will incur a tax equal to what would have been imposed plus interest.

*Rollovers*

SEPL distributions are not eligible for rollover treatment. Therefore, the taxpayer is not allowed to transfer these payments to other retirement accounts if, for example, he subsequently decides that he would like to effectively stop receiving payments from the SEPL plan.

If a taxpayer does roll over a SEPL distribution, it will break the SEPL plan—meaning that all prior distributions the taxpayer made trying to avoid the penalty tax will get hit with the extra 10 percent.

In the past, another rollover situation had the potential to foul up an implemented SEPL strategy. IRS regulations implied that a partial or complete rollover of the account from which Section 72(t) distributions were being made would be considered a material modification. As such, a rollover of the account would cause the 10 percent penalty tax to apply.

Fortunately, Section 323 of the SECURE Act 2.0 changed that. A partial rollover from one qualified account to another is now allowed during SEPL distributions without being considered a material modification.

*Consequences of Failure*

If, for any reason, a taxpayer's SEPL plan is broken and the calculations do not match the chosen method, the IRS must impose Code Section 72(t)(1) and (4), which states that his tax

> shall be increased by an amount, determined under regulations, equal to the tax which (but for [the SEPL plan]) would have been imposed, plus interest for the deferral period.

Because the statute uses the language "shall be," the IRS *must* impose the 10 percent surtax and interest—Congress did not give the IRS the option to waive the 10 percent even if it was the result of a slight, inadvertent miscalculation.

*IRS Exceptions*

While the Code strictly prohibits taxpayers from modifying the payments under the SEPL plan for five or more years, the IRS gives some leeway as to what constitutes a modification.

Revenue Ruling 2002-62 supplies an exception to the five-year rule. If a taxpayer began receiving SEPL distributions using either the fixed amortization method or the fixed annuitization method, he may subsequently switch to the RMD method without it being considered a modification of the series of payments. Therefore, no 10 percent penalty would be incurred on the change in methods.

This ruling does not allow a taxpayer to revert back to the previous method, nor does it allow a taxpayer to switch from the RMD method to another method.

If a taxpayer dies or becomes disabled, the taxpayer or beneficiary is no longer required to continue a SEPL plan even if he is younger than 59 ½ or has been receiving payments for fewer than five years.

The IRS has also provided some guidance with Private Letter Rulings (PLRs) addressing specific instances where the taxpayer changes his SEPL distributions due to a divorce. Note, however, that PLRs cannot be relied upon as precedent, and they only bind the IRS to the requesting taxpayer.

First, in PLR 9739044, pursuant to a divorce, the taxpayer and his spouse split their three IRAs equally. The IRS held that so long as long as the ex-spouses continued withdrawing their respective shares of the SEPL payments, this would not constitute a modification and would not trigger the 10 percent penalty being applied.

Later, in PLR 200027060, the taxpayer's ex-spouse was awarded a portion of the taxpayer's IRA. The IRS ruled that the ex-spouse does not need to continue receiving SEPL payments on her portion of the IRA because the transfer of the IRA was a tax-free transfer under Section 408(d)(6). The IRS did not address the husband's SEPL obligations but based on PLR 9739044 described in the preceding paragraph, the husband should be able to reduce his SEPL payment schedule to show the decrease of his IRA account.

The IRS released PLR 200050046 addressing another husband's situation in a similar fact pattern to that in PLR 200027060. The IRS ruled that a reduction in the annual SEPL payments due to the divorce does not constitute a "subsequent modification" and therefore does not incur the 10 percent additional tax imposed.

In PLR 201051025 the Service concluded that the fact that the amount of the annual SEPL amount was paid in a single sum in the first year and in monthly distributions thereafter would not be considered a material modification.

*Court-Enabled Exceptions*

If a taxpayer is currently on a SEPL payment plan with respect to his retirement plan *and also* withdraws funds pursuant to a statutory exception listed above, do these additional distributions constitute a modification to the SEPL?

In *Benz v. Commissioner*, 132 T.C. 15 (U.S.T.C. 2009), the Tax Court addressed this issue,
specifically with regards to the Section 72(t)(2)(E) IRA penalty tax exception for higher education expenses. Here the taxpayer was receiving penalty-free distributions pursuant to his SEPL plan. Within five years of the first payment, the taxpayer withdrew additional distributions for qualified higher education expenses.

The distributions were not subject to the penalty because they qualified for an exception, but the IRS argued that they constituted an impermissible modification to the SEPL election under Section 72(t)(4) and accordingly sought back taxes plus interest on the previous SEPL payments.

The Tax Court disagreed, holding that "a distribution that satisfies the statutory exception for higher education expenses is not a modification of a series of substantially equal periodic payments." In other words, a taxpayer's SEPL plan was not busted merely because he withdraws additional qualified higher education funds from the same IRA.

After the *Benz* decision was published, some experts believed its central issue might be retested, perhaps with a different result. With 15 years having passed since the court ruling, that seems unlikely. However, a taxpayer should check with his tax professional and analyze the risks associated with making other exception-qualifying distributions during a SEPL stream.

*Multiple Retirement Accounts*

When calculating SEPL payments, the taxpayer does not have to aggregate each of his retirement accounts. He can pick and choose which accounts to include in calculating his SEPL payments. This might be useful if a taxpayer wants to withdraw an amount less than the calculated SEPL payments.

For example, assume Morris has not yet reached age 59 ½ but wants to withdraw $1,000 per month from his IRA. Unfortunately, he found that his SEPL payments require him to withdraw at least $2,000 per month—twice the amount he'd prefer. If Morris owned two IRAs of equal value, then he could take early withdrawals of only one account, resulting in reaching his goal of $1,000 per month in SEPL-compliant distributions.

On the other hand, the taxpayer may prefer to aggregate accounts in calculating the amount of his SEPL payments. This would be beneficial if he would like to withdraw as much as possible now rather than later. If the taxpayer chooses to aggregate, he is permitted to withdraw such SEPL payments solely from one account or from a combination of any accounts. However, any off-schedule distribution from the combination of accounts used to calculate the precise SEPL distributions will be considered a material modification and cause imposition of the penalty tax on all prior distributions.

*Section 72(q) for NQDA Distributions*

As with Section 72(t) for qualified plans, Section 72(q) imposes the 10 percent penalty tax on early distributions (i.e., those taken before the taxpayer reaches age 59 ½) from nonqualified plans:

> **(q) 10-percent penalty for premature distributions from annuity contracts**
>
> > **(1) Imposition of penalty**
> > If any taxpayer receives any amount under an annuity contract, the taxpayer's tax under this chapter for the taxable year in which such amount is received shall be increased by an amount equal to 10 percent of the portion of such amount which is includible in gross income.

As with the rules under subsection (t), the 10 percent penalty applies to the part of the distribution that has to be included in gross income, and it is in addition to any regular income tax on that amount.

The language is almost identical except that subsection (q) refers the 10 percent tax as a "penalty" while subsection (t) calls it an "additional tax."

Section 72(q) also provides exceptions from the 10 percent penalty on certain distributions. As with Section 72(t), NQDAs are provided with an exception for early distributions that are part of a series of substantially equal periodic payments made for life. SEPL distributions for NQDAs work in a similar fashion to those under qualified plans.

The main difference between NQDAs and qualified retirement plans is that NQDAs are afforded fewer exceptions to the 10 percent penalty tax on early distributions. Unlike Section 72(t), early distributions from NQDAs are subject to the 10 percent penalty even if they are applied to medical expenses, qualified higher education expenses, QDROs, first-time home purchases, and subject to cessation of employment after the age of 55.

Finally, distributions under an immediate annuity contract that has been purchased with after-tax funds are not subject to the 10 percent penalty tax—no matter how long or short the payout period. See Code Section 72(q)(2)(I).

*MECs Too*

MECs are also subject to an additional tax for early distributions similar to Section 72's subsections (t) and (q):

> **(v) 10-percent additional tax for taxable distributions from modified endowment contracts**
>
> **(1) Imposition of additional tax**
> If any taxpayer receives any amount under a modified endowment contract (as defined in section 7702A), the taxpayer's tax under this chapter for the taxable year in which such amount is received shall be increased by an amount equal to 10 percent of the portion of such amount which is includible in gross income.

There are only two exceptions to early distributions (i.e., before the taxpayer reaches age 59 ½). First, distributions made under a SEPL program (as discussed above) are not subject to the additional tax. Second, distributions attributable to the taxpayer's becoming disabled are not subject to the 10 percent additional tax.

*Partial 1035 Exchanges*

In the past, there was a concern that performing a partial 1035 exchange of an NQDA from which SEPL distributions were being made would be a material modification.

Fortunately, Section 323 of the SECURE Act 2.0 changed that—just as it did for partial rollovers from qualified plans. A partial 1035 exchange from one annuity to another is now allowed during SEPL distributions without being considered a material modification.

## CONCLUSION

A SEPL plan is a useful tool to help maximize retirement income for an individual looking to access his retirement account before he reaches age 59 ½. While the taxpayer may not be able to withdraw as much as he would like under a SEPL plan, he will be able to avoid the 10 percent penalty if done correctly.

However, if the taxpayer does not set up the plan correctly or deviates from the payment schedule, even if inadvertently, the consequences can be expensive.

For those relying on retirement accounts sooner rather than later, the SEPL method of receiving distributions may be a good way to withdraw funds to meet current needs without incurring additional taxes. These plans can prove to be an effective tool for minimizing one's tax burden.

Because distributions are calculated based on life expectancy, clients sometimes struggle to make SEPL distributions meet their actual needs. A professional should always guide the client before, during, and after retirement payments begin to maximize options and minimize tax risks.

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## IN THIS ISSUE OF ADVISOR'S BULLETIN



### *Building Protecting and Perpetuating Family Wealth*

LWA strives to develop and maintain sound financial plans designed to achieve our client's wealth accumulation, preservation and transfer objectives, with the goal of preserving their wealth for multiple generations. We provide these services in a confidential and consultative manner, building life-long relationships based upon education, trust, communication and service.