Substantially Equal Periodic Payments Revisited

Take-Away: If an individual elected to take substantially equal periodic payments (SEPPs) to avoid the 10% early distribution penalty, he/she may want to consider making a one-time switch to a different method to calculate their annual SEPP distribution with the recent market turmoil

Background: In the past we have covered the special rule in the Tax Code that permits withdrawals from an IRA prior to age 59 ½ without penalty, called the substantially equal periodic payment rule (SEPP). IRC 72(t) permits distributions from an IRA (or 401(k) or 403(b) account)) without any penalty before age 59 ½ However, there are several rules to comply with to avoid incurring the early distribution penalty of 10%.

An IRC 72(t) payment plan must continue for five years or until age 59 ½, whichever comes *later* (except for death or disability.).

Generally, the same distribution method must be maintained during the entire SEPP distribution period.

The SEPP cannot be modified during the SEPP distribution period. If a change is made, that will trigger retroactive early distribution penalties.

The IRA cannot be converted to a Roth IRA during the SEPP period, as that would be a prohibited modification that triggers the retroactive penalties.

There are three SEPP distribution methods approved by the IRS: (i) RMD; (ii) amortization; or (iii) annuitization. If the goal is to use the IRS-method that produces the largest IRC 72(t) payment with the smallest IRA balance, this normally results in the selection of either the amortization or annuitization method of SEPP distribution.

Declining Market Hardship: However, the recent downturn in the market creates a genuine problem for those individuals who have accessed their retirement accounts ‘early’ by electing to use the SEPP distribution method. If the balance of the individual's IRA has dropped 20%, that results in annual SEPP payments that are a much larger percentage of his/her IRA balance.

One-Time Switch: Fortunately, there is some limited relief in this situation where an IRA's balance has suddenly dropped in value. Revenue Ruling 2002-62 permits a one-time switch from either the amortization or annuitization method to the RMD method. Such a switch in SEPP distribution methods will reduce the size of the SEPP payment when the IRA balance has shrunk due to a stock market downturn. However, if a switch is made to a different method, it is permanent until the end of the original IRC 72(t) SEPP period.

Example: At age 55, when she was lost her job in her employer's workforce reduction, Pauline has consistently taken IRC 72(t) payments from her rollover IRA for the past three years, following the IRS-approved amortization method. With the recent downturn in the market, Pauline's IRA investments have lost considerable value. Pauline's required SEPP payments, set three years ago, now eat up substantially more of her IRA. To reduce the drawdown on her IRA, Pauline elects to switch from the IRS approved amortization method to the IRS approved RMD method to calculate the remainder of her SEPP payments, which reduces the size of Pauline's annual SEPP distribution. Pauline must still adhere, though, to the original 5-year SEPP period and she can make no other modifications during that remaining time.

Conclusion: Market volatility is unpleasant, to say the least. But it can also present a potential opportunity, such as the ability to switch the method to calculate distributions under a SEPP plan.