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Substantially Equal Periodic Payments: An Exception to the Premature Distribution Tax

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Introduction

Unless you qualify for an exception, taxable amounts you withdraw from an IRA or qualified retirement plan before age 59½ are generally subject to a federal 10 percent premature distribution tax (and possibly a state penalty tax, too). This premature distribution tax is assessed in addition to any federal (and possibly state) income tax due. Fortunately, Section 72(t) of the Internal Revenue Code lists several exceptions to this tax. One of the exceptions to this 10 percent premature distribution tax involves taking a series of "substantially equal periodic payments" from your IRA or qualified retirement plan.

Tip: Similar rules apply to "nonqualified" annuities (that is, annuities that are not IRAs or part of a qualified retirement plan) under Section 72(q) of the Internal Revenue Code.

What are substantially equal periodic payments?

Substantially equal periodic payments are amounts you must withdraw from your IRA or qualified retirement plan not less frequently than annually for your life (or life expectancy) or the joint lives (or joint life expectancy) of you and your beneficiary. To meet the substantially equal periodic payments exception, you must use an IRS-approved distribution method and take at least one distribution annually. There are three IRS-approved methods for calculating substantially equal periodic payments, each of which uses a factor representing your life expectancy (or the joint life expectancies of you and your beneficiary). It's important to understand how these methods work and how recent tax law changes may affect your choice of method.

Caution: With respect to a qualified retirement plan, this exception to the premature distribution tax applies only if your periodic payments begin after your separation from service.

How long must the payments continue?

The payments from your IRA or retirement account must continue for at least five years, or until you reach age 59½, whichever is later. If you modify the payments (e.g., by taking a smaller distribution than you should have) or change from one approved method to another, you generally will be subject to the 10 percent premature distribution tax on the taxable part of all payments made to you before you reached age 59½ (unless the modification was due to death or disability). In addition, interest may be imposed.

Tip: However, Revenue Ruling 2002-62 allows a one-time method change from either the fixed amortization method or the fixed annuitization method to the required minimum distribution (RMD) method. See below for details.

Example(s): Assume John began taking annual distributions from his traditional IRA account three years ago, when he was 43 years old. (John has taken these distributions according to an IRS-approved method.) John does not take a distribution this year. Because John's payment stream has been "modified," the 10 percent penalty will now apply retroactively to all of his previous distributions, and interest may also be imposed. (A state tax penalty may apply, as well.)

The five-year period begins on the date of the first withdrawal, so no modification can be made before the fifth anniversary of that withdrawal. This is true even if you turn age 59½ before the fifth anniversary of that withdrawal.

Example(s): Assume that John began taking annual distributions from his traditional IRA on October 1, 2005, when he was 57½ years old. He also took the correct annual distributions in 2006, 2007, and 2008 (when he was age 60). Even though he was over age 59½ on October 1, 2008, he

must take one more required distribution by October 1, 2009. Otherwise, he'll be subject to the 10 percent penalty on the taxable portion of the distributions he took when he was under age 59½.

Tip: What if you follow an IRS-approved method of determining substantially equal periodic payments and your account value drops to zero in year three, preventing you from complying with the five-year rule? IRS rules provide that you won't be subject to the 10 percent premature distribution tax simply because your account ran dry.

How do you calculate your substantially equal periodic payments?

There are three IRS-approved methods for determining annual payments that qualify as substantially equal: the RMD method, the fixed amortization method, and the fixed annuitization method. These methods may involve the use of a life expectancy table, an appropriate interest rate, and an initial IRA or retirement plan account balance valuation date. Here's what you need to do:

- Select the appropriate life expectancy or mortality table
- Select an interest rate (but only if you're using the fixed amortization or fixed annuitization method)
- Select an initial IRA or retirement plan account balance valuation date
- Select one of the three IRS-approved methods for determining substantially equal periodic payments

Tip: To ensure that your distributions will qualify for the exception to the premature distribution tax, get professional advice.

Life expectancy tables

A life expectancy table must be used in conjunction with each of the three calculation methods. A mortality table is used with the third method--the fixed annuitization method. Currently, the applicable life expectancy tables are (1) the Uniform Lifetime Table (found in Appendix A of Revenue Ruling 2002-62), (2) the Single Life Table (set forth in Q&A-1 of Section 1.401(a)(9)-9 of the Income Tax Regulations), or (3) the Joint and Survivor Table (set forth in Q&A-3 of Section 1.401(a)(9)-9 of the Income Tax Regulations).

Tip: If you're interested in receiving predictable distribution amounts, you may want to use either the Single Life Table or the Uniform Lifetime Table. (The Single Life Table will provide you with larger payments than the Uniform Lifetime Table.) That's because the person you select as your account beneficiary is largely irrelevant with these tables. Also, changing your beneficiary after you've begun distributions from your account won't affect the size of your distributions.

Tip: If you want to be able to affect the size of your distributions by changing your designated beneficiary, you may be more interested in the Joint and Survivor Table (used in conjunction with the RMD method). If you select the Joint and Survivor Table, the factor used to determine the first payment in the series is based on the joint life expectancy of you and your actual designated beneficiary. The identity of the beneficiary for this calculation is determined on January 1 of each distribution year (even if you change beneficiaries later in that year or have done so in prior years). The age that is used for the beneficiary is the age on the beneficiary's birthday in that year. Therefore, changing your designated beneficiary may change the size of your distributions. (There are special rules where there is more than one designated beneficiary--the designated beneficiary rules of Section 401(a)(9) are used.)

Tip: However, if you use the fixed annuitization or fixed amortization method with the Joint and Survivor Table, changing your beneficiary will generally not affect the size of your payments (because you take out a fixed amount each year), unless you later switch to the RMD method (see below).

Interest rate

If your method of calculating substantially equal periodic payments involves the use of an interest rate, the interest rate (for distributions on or after January 1, 2003) may not be more than 120 percent of the federal mid-term rate determined for either of the two months immediately preceding the month in which the distribution begins. You can find the appropriate interest rate on the IRS's website.

Example(s): If the federal mid-term rate were 3.50 percent in October 2009, 120 percent of this amount would equal 4.20 percent. If the federal mid-term rate in September 2009 were 3.75 percent, 120 percent of this amount would be 4.5 percent. Therefore, if you took a distribution in November 2009, and required an interest rate for your calculation, your interest rate could not exceed 4.5 percent.

Tip: Prior to the effective date of Revenue Ruling 2002-62, you could use any "reasonable interest" when calculating substantially equal periodic payments.

Account balance

No matter which distribution method you choose, you'll need to use an account balance to compute your periodic payments. For your first distribution, Revenue Ruling 2002-62 says that your account balance must be determined "in a reasonable manner, based on the facts and circumstances."

The Revenue Ruling has an example where an IRA with daily valuations made its first distribution on July 15, 2003. The ruling stated that it would be reasonable to determine the yearly account balance when using the required minimum distribution method based on the value of the IRA from December 31, 2002, to July 15, 2003, and then, for subsequent years, to use the value either on December 31 of the prior year or on a date within a reasonable period before that year's distribution.

For subsequent distributions, account balances are generally relevant only if you use the RMD method. That's because payments are fixed under the annuity and amortization methods. So, for a subsequent distribution under the RMD method, you'd use the value of your account either on December 31 of the prior year or on any date within a reasonable period before this year's distribution. This provides you with some flexibility--if you want to take a larger distribution, choose the highest account balance during the prescribed time period.

Caution: Under all three methods, certain changes to your IRA account balance will be construed as a "modification" to your series of substantially equal periodic payments, triggering the 10 percent premature distribution tax. Bear in mind that your account balance, for purposes of calculating your periodic payments, is the balance on a particular date--the date you selected to determine your first distribution. A modification to your series of payments will occur if, after that date, there is (1) an addition to your IRA account balance other than through gains or losses, (2) a nontaxable transfer of part of your account balance to another retirement plan, or (3) a rollover of the substantially equal periodic payment received from your IRA, resulting in such amount not being taxable.

Tip: If you have more than one IRA and want to take substantially equal periodic payments, you're not required to aggregate all of your IRAs. You can consider the account balance of only one of your IRAs, or you can elect to aggregate some or all of the account balances of your IRAs. You can use tax-free rollovers to ensure that the IRA that will be the source of your periodic payments contains the exact amount necessary to generate the payment amount you want.

What is the required minimum distribution method?

With the RMD method, you calculate each annual distribution by dividing your IRA or retirement account balance (revalued each year) by a life expectancy factor from whichever life expectancy table you selected. You can choose any of the three tables: the Uniform Lifetime Table, the Single Life Table, or the Joint and Survivor Table.

Caution: Once you've chosen a table to be used in conjunction with the RMD method, you must

stick with it.

Each year, your distribution amount will vary. That's because your distribution is recomputed annually, based upon the new account balance and your reduced life expectancy.

Example(s): Assume Jill decided to use the RMD method (and the Uniform Lifetime Table) to take substantially equal periodic payments from her IRA on January 3, 2008, when she turned 50. Jill's IRA was worth \$50,000 on December 31, 2007. According to the table, the life expectancy figure for a person age 50 is 46.5. Jill divided her IRA balance (\$50,000) by the life expectancy (46.5) to arrive at the amount she had to withdraw from her IRA in 2008--\$1,075.26. In 2009, Jill will be 51. She'll divide her 2008 year-end IRA balance by her new life expectancy figure (45.5) to arrive at her 2009 distribution.

Tip: If you use the RMD method and go with the Uniform Lifetime Table for life expectancies, changing your beneficiary will make no difference. However, if you're using the Joint and Survivor Table, the beneficiary whose age is used as the designated beneficiary is determined as of January 1 of each distribution year. Therefore, changing your designated beneficiary may change the size of your distributions. (There are special rules where there is more than one designated beneficiary--the designated beneficiary rules of Section 401(a)(9) are used.)

The variable size of the annual distributions under this method has its advantages and disadvantages. On the plus side, basing the size of distributions on the actual size of your IRA or retirement plan account as it changes each year will ensure that your distributions don't exhaust the funds in your account (as may happen with distributions of a fixed size when a substantial account has declined in value). Annual revaluation of the size of your account also means that the investment performance of your account will affect the size of your annual distributions. If the value of your account increases through good investment performance, your annual distribution will also increase; if the value of your account decreases, your annual distribution will also decrease. On the downside, though, you may be forced to take smaller distributions in a year when you need more income if your distributions are based on an account balance that has declined in value.

What is the fixed amortization method?

Unlike the RMD method, which produces a distribution amount that varies from year to year, the fixed amortization method yields a fixed annual amount. To use this method, you must choose an appropriate interest rate (see earlier) and one of the three life expectancy tables. The annual payment for each year is determined by amortizing your IRA or retirement account balance in level amounts over a specified number of years determined in accordance with the life expectancy table and interest rate you select.

Your account balance, your life expectancy table, and your annual payment are determined once for the first distribution year and the annual payment is the same in each year thereafter.

Example(s): Assume Steve takes an IRA distribution in 2009 (when he is 52 years old) according to the amortization method. He chooses the Single Life Table, under which he has a life expectancy of 32.3 years. For calculation purposes, he uses an interest rate of 3 percent and an account balance of \$100,000 (which was the value of his IRA on December 31, 2008). Steve must receive \$4,877.32 annually until he reaches age 59½. This is determined by amortizing \$100,000 over 32.3 years at 3 percent interest.

Although an on-line calculator may be able to perform the necessary amortization calculation for you fairly quickly, an especially easy method is to use a spreadsheet. With a typical spreadsheet, the following formula will generally perform the amortization:

=PMT(interest rate, number of years, present value)

So, using the above example, you'd type the following into any cell in the spreadsheet, and then press Enter:

=PMT(.03,32.3,100000)

The result in this case is \$4,877.32.

What is the fixed annuitization method?

Like the fixed amortization method, the fixed annuitization method yields a fixed annual distribution amount. To use this method, you must determine the appropriate account balance, choose an appropriate interest rate (see earlier), and determine an annuity factor derived from using the mortality table in Appendix B of Revenue Ruling 2002-62.

Here, the annual payment for each year is determined by dividing your IRA or retirement account balance by an annuity factor. The annuity factor is the present value of an annuity of \$1 per year beginning at your age in the first distribution year and continuing for your life (or the joint lives of you and your beneficiary). The annuity factor is derived using the mortality table found in Appendix B of Revenue Ruling 2002-62.

With the fixed annuitization method, your account balance, your annuity factor, your interest rate, and your annual payment are determined once for the first distribution year and the annual payment is the same amount in each year thereafter.

Prior to the effective date of Revenue Ruling 2002-62, you could use any "reasonable mortality table" for determining life expectancy under the annuity method.

Example(s): Assume John began taking distributions from his \$100,000 IRA in 2000, when he was 50 years old. Using the UP-1984 Mortality Table (which was permissible in 2000) and an interest rate of 8 percent, John's annuity factor would be 11.109. Therefore, John took out \$9,002 from his IRA in 2000, and continues to withdraw that same figure each year. (That's calculated by dividing his \$100,000 account balance over the 11.109 annuity factor.)

Caution: The annuity method is the most difficult of the three to calculate, although there are on-line calculators for computing appropriate annuity amounts.

How did Revenue Ruling 2002-62 change matters?

In the past, IRS Notice 89-25 provided guidance on the calculation of substantially equal periodic payments. The ruling released by the IRS on October 3, 2002--Revenue Ruling 2002-62--modifies Q&A 12 of Notice 89-25. Revenue Ruling 2002-62 applies to substantially equal periodic payments commencing on or after January 1, 2003.

Revenue Ruling 2002-62 provides guidance regarding the calculation of substantially equal periodic payments by clarifying the interest rate to be used, the life expectancy tables to be used, and the mortality table to be used for annuity purposes. In addition, Revenue Ruling 2002-62 allows a one-time change in calculation method from the fixed amortization or fixed annuitization method to the RMD method. This change is designed to provide relief to taxpayers who have been forced to take fixed withdrawals (under either of the two fixed amount methods) from IRAs and retirement plan accounts that have declined in value and who may be concerned with outliving their account balances. (With the RMD method, a decrease in the value of your account automatically translates into a lower distribution amount.)

Tip: This one-time change is not considered to be a "modification" subjecting you to the 10 percent premature withdrawal tax--it's a penalty-free switch. But bear in mind that your one-time switch to the RMD method is irrevocable.

Caution: It is not entirely clear if you can choose a new life expectancy table when you switch from the fixed amortization or fixed annuitization method to the RMD method, if your payments began in 2003 or later. While likely, further IRS clarification is necessary.

Although January 1, 2003 is the effective date of Revenue Ruling 2002-62, the ruling also provides that if your substantially equal periodic payments began prior to 2003, you may also switch from the amortization or annuitization method to the RMD method. The ruling specifically states that you may also select a new life

expectancy table.

Example(s): Assume John began taking substantially equal periodic payments (under the fixed amortization method) from his traditional IRA in 2002. At the time, his IRA was worth \$1 million. Using an 8 percent interest rate and a single life expectancy of 33.3 (at age 51), John was required to withdraw \$86,682 from his account each year.

Example(s): In 2009, at the age of 58, the value of John's IRA has decreased to \$500,000. Therefore, continuing to take out \$86,682 from his account each year would exhaust his IRA in a relatively short time. John decides to make a one-time switch to the RMD method. Because his payments began prior to 2003, John can choose a new life expectancy table as part of his switch to the RMD method. John's IRA beneficiary is his wife, who is also age 58. If John uses the 2009 account valuation date, the life expectancy tables yield the following distribution amounts for 2009:

Example(s): $\$500,000 / \text{Factor from Single Life Table for Age 58 (27.0)} = \$18,518.51$

Example(s): $\$500,000 / \text{Factor from Joint and Survivor Life Table for Ages 58 and 58 (32.8)} = \$15,243.90$

Example(s): $\$500,000 / \text{Factor from Uniform Lifetime Table for Age 58 (38.7)} = \$12,919.89$

Example(s): Therefore, John may want to use the Uniform Lifetime Table if he'd like to minimize his distribution amounts.

Tip: If you began receiving substantially equal periodic payments prior to 2003, using one of the three methods in Notice 89-25, you can continue receiving payments under that method after 2002. You aren't required to make any changes.

Must you report your distribution method to the IRS?

You should receive a Form 1099-R at the end of the year from your IRA trustee or retirement plan administrator, indicating that you took a distribution from your account. In box 7 of that form, code 2 may be listed, indicating that you've met one of the penalty exceptions. If your provider lists a code 1 in box 7 (indicating that you're under age 59½ and the payer is not aware of any exception to the 10 percent premature distribution tax), you'll need to complete IRS Form 5329 and attach it to your federal income tax return. On Form 5329, you'll check off that the substantially equal periodic payments exception applies. (You may also need to file a similar form with your state.)

Caution: Although you don't have to "show your work" or attach any computations, it would probably be wise to keep your math work on file at home.

Tip: For more information about the 10 percent premature distribution tax, its exceptions, and reporting requirements, see IRS Publication 590.

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