

Early Retirement Plan Withdrawals Using Internal Revenue Code Section 72(t) and Variable Annuity Living Benefit Riders

Benefit: By using IRC Sec. 72(t) and variable annuity living benefit riders clients are able to access their IRAs before age 59 1/2 with no premature distribution penalties while lowering the risk that the portfolio will be harmed by those withdrawals in a declining market.

The Client: Robert Barnhart, 52, is a middle management executive. He stated that because of health reasons he wants to retire early and “enjoy the rest of my life.”

Mr. Barnhart has \$985,000 in his 401(k). His youngest child has just graduated college and he feels no further need to contribute to her support. He has health insurance through his wife’s employer. In addition to her income, he will need \$37,000 annually for he and his wife to maintain their current lifestyle.

The Problem: Mr. Barnhart is still 7 ½ years away from turning age 59 ½. Any withdrawals taken from the retirement plan will be taxed at ordinary income tax rates and will be assessed an early withdrawal penalty of 10%.

The Tool: IRC Sec. 72 (t)/variable annuity living benefit riders.

The IRS does allow several exceptions to the 10% early withdrawal penalty. One exception states that the penalty is waived if the distributions are part of “substantially-equal periodic payments”. These payments must be taken until the participant turns 59 ½ or 5 years, whichever is greater. If any changes are made to these distributions – such as a scheduled withdrawal is not taken or additional money is taken from the account – the 10% penalty plus interest will be charged to all the money taken including prior years.

However, there is some flexibility in setting up these withdrawals. In particular, Sec. 72 (t) withdrawals are applied per account and not per taxpayer. For example, a taxpayer can divide a single IRA into several different accounts and start a Sec. 72 (t) withdrawal on one of those without applying it to any others.

A major risk that people using the 72(t) distributions face is a perfect storm of a severe market downturn combined with being forced to take those “substantially-equal periodic payments”. Withdrawing funds in a down market is a recipe for capsizing a retirement account’s long term viability. However, altering the payments to try to preserve an account during a downturn will trip the 10% penalty trap.

This risk can be mitigated by using living benefit riders now offered by several variable

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