EARLY RETIREMENT A CONCERN? RECENT SEPP CHANGE CAN HELP

Substantially equal periodic payments (SEPPs), often referred to as 72(t) or 72(q) payments, are ways to access retirement funds prior to age 59½ without the additional 10% federal tax.

On January 18, 2022, the Internal Revenue Service (IRS) released Notice 2022-6, which replaces the guidance in Revenue Ruling 2002-62 and Notice 2004-15 for any series of payments beginning on or after January 1, 2023. This guidance may also be used for a series of payments beginning in 2022. A key aspect of Notice 2022-6 is a change in two of the calculation methods for SEPPs—which could benefit retirees. Here's how.

Substantially Equal Periodic Payments (SEPPs) Review

SEPPs are an exception for clients younger than age 59½ that allows withdrawals from retirement accounts to avoid the premature/early withdrawal additional 10% federal tax. SEPPs are called 72(t) for qualified assets or 72(q) for nonqualified assets, and financial professionals have used this option for clients who need income prior to reaching age 59½. Once the SEPP program is started, clients will need to continue the periodic payments for five years or until they reach age 59½—whichever is reached latest. Termination or adjustment of the periodic payments, called a modification, may result in tax consequences and penalties. Clients should consult with a tax professional prior to establishing and/or modifying the SEPPs.

SEPPs Have Three Calculation Methods

- **Required minimum distributions (RMDs):** This calculation is based on the client's year-end account balance, divided by the client's life expectancy (uniform, single, or joint/last survivor). This method yields the lowest payout amount and changes each year based on the calculation.
- **Fixed amortization:** This method consists of the client's account balance amortized over a specific number of years based on the client's life expectancy (single or joint/last survivor) and an interest rate. The interest rate will be discussed below. The amount for this calculation remains the same each year.
- **Fixed annuitization:** This calculation is based on the client's account balance and annuity factor. This method typically yields the highest payout amount and remains the same each year.

Additional Considerations for SEPPs

- Under Notice 2022-6, which replaces the guidance in earlier Revenue Ruling 2002-62 and Notice 2004-15, a one-time change from the amortization or annuitization method can be made to the RMD method. Changing to the RMD method likely will reduce the payout amount.

- Prior to the recent changes, the interest rate used for the amortization and annuitization methods is no higher than 120% of the federal mid-term rate. It also may be called "reasonable interest rate," and it is published in IRS revenue rulings for either of the two months immediately before distribution begins.

What's Changed and How Can It Help My Clients?

The amortization and annuitization methods use an interest rate to calculate payments, as mentioned previously. The higher the rate, the higher the payment these methods will yield. Historically, the federal mid-term rate has been low. For May 2022, the rate is 3.01%. What's the excitement regarding the new change? Let's take a look.

Notice 2022-6 states that 72(t) payments could use the greater of either 120% of the federal mid-term rate or up to 5% in calculating the amortization and annuitization methods. As mentioned previously, the higher the rate, the higher the payment. This change will allow clients to withdraw more income if needed to help bridge the gap to age 59½.

Example: Based on a $500,000 account, this client is age 55 and considering early retirement:

- Amortization payment before Notice 2022-6 and May AFR 3.01%: $24,743
- Amortization payment after Notice 2022-6 using 5% interest rate: $31,807
- Annuitization payment before Notice 2022-6 and May AFR 3.01%: $24,636
- Annuitization payment after Notice 2022-6 using 5% interest rate: $31,428

The significant increase to the payments could sway the client to move forward with early retirement.

Reach out to clients who have considered early retirement. This change may help make their decisions easier. Early retirees with large, qualified accounts can access a portion of that asset and roll it over to an IRA to begin receiving income. Generally, retirees should try to spend down assets for tax efficiency. This means they should try to spend taxable accounts first, tax-deferred (401(k), IRAs, etc.) next, then tax-free accounts. The new SEPP interest-rate option can help retirees spend down their accounts to their advantage.

This change was just enacted earlier this year, which means companies who offer 72(t/q) calculators may not be able to support the new calculation methods. Be sure to reach out directly to discuss their policies and procedures on setting up the program.

Additional Resources and Links

Determination of Substantially Equal Periodic Payments

Substantially Equal Periodic Payments

72(t) Early Distribution Analysis

For more information about retirement planning, please contact our Retirement Strategies Group at RSG@PacificLife.com or (800) 722-2333, ext. 3939.
PacificLife.com

VLC2637-0522W

This material is educational and intended for an audience with financial services knowledge.