

A Practical Guide To

Substantially Equal Periodic Payments

And Internal Revenue Code §72(t)

By

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Fourth Edition

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IMPORTANT NOTICE FROM THE AUTHOR

For thirteen years, the implementation of “substantially equal periodic payments”, (SEPPs), were governed by the Internal Revenue Code §72(t)(2)(A)(iv), IRS Notice 89-25¹, and a collection of approximately 100 private letter rulings issued to various taxpayers over the period of 1989 through mid-2002. In October, 2002, the Internal Revenue Service issued Revenue Ruling 2002-62² which effectively replaced Notice 89-25 commencing January 1, 2003.

Although only a seven page document, this ruling was and is extremely significant. It literally created a whole new set of rules regarding both in-progress as well as new SEPP programs. In general, this ruling is two rulings in one:

- (1) It provides for new interpretations of IRC §72(t)(4), specifically what constitutes a “modification” and what does not; thus, providing some relief mechanisms to taxpayers with existing SEPP plans that were prematurely running out of IRA assets. Further, a one-time method conversion was created to allow changing without penalty to the “required minimum distribution” method.
- (2) Effective, January 1, 2003, newly launched SEPP plans will be materially limited compared to the rules that were in place from 1989 through December 31, 2002 such that the maximum amount of distributions allowed, holding the IRA balance constant, are reduced in the range of 25% to 30%³.

As a result of the new ruling as well as subsequent pronouncements, this text has undergone a complete re-write during the Fall of 2004. Anyone who has purchased any of the first three editions should discard it. For a small fee, the author will happily replace an older edition by simply e-mailing a request to themarblegroup@wispertel.net.

INTRODUCTION

At the dawn of the twenty-first century, many taxpayers have acquired substantial retirement assets in a variety of tax deferred vehicles, including:

¹ 1989-1 Cumulative Bulletin 662.

² 2002-42, Internal Revenue Bulletin 710, October 21, 2002. A complete copy of this ruling has been reproduced in the appendices of this text.

³ This relative reduction in the maximum allowable annual distribution amount is primarily caused by limiting the interest rate assumption to 120% of the applicable mid-term federal rate. Prior to 2003, many taxpayers adopted SEPP plans using materially higher interest rate assumptions.

- Employer sponsored plans, such as profit sharing plans (predominately created under IRC §401(a) & §403(b)), employee contribution plans under IRC §401(k), and the conversion or lump sum distribution from older defined benefit plans.
- Personally initiated traditional individual retirement accounts, (IRAs⁴) including those funded by annual contributions and rollovers.
- Simplified employee pension accounts (SEPs).
- Recently created ROTH IRA accounts through both regular contributions as well as conversions from traditional IRA accounts.

All distributions from the aforementioned accounts are governed by IRC §72(t) which, in addition to regular federal income tax, imposes a 10% surtax on ALL distributions unless one or more of the twelve exceptions are applied. However, more and more frequently, taxpayers in their thirties, forties and early fifties are voluntarily (and sometimes involuntarily) looking to their retirement assets and contemplating some form of early retirement⁵. Further, they are perplexed as to how to access these assets without undo tax burden as required by IRC §72(t).

As of September, 2004, IRC §72(t) provides twelve reasons or exceptions that qualify taxpayers to withdraw monies from their 401(k)s or IRAs (collectively called “deferred accounts”⁶) and avoid the 10% surtax. These exceptions generically fall into two types: transaction or cause specific and process/multi-year. There are seven transaction or cause specific exceptions, all of which will be discussed later in the text. As an example, exception #10 is the ability to withdraw some monies while one is unemployed and need to make health insurance premium payments⁷. All seven of these transaction-specific exceptions are either severely limited in scope or are present for coordination purposes. Conversely, the primary focus of this guide is to closely examine the other five “process” or “multi-year” exceptions. They are:

- §72(t)(2)(A)(I) Age 59 ½

⁴ Included here are both traditional IRAs (governed by IRC §408(a)) as well as Roth IRAs (governed by IRC 408A).

⁵ In this context we mean a whole or partial shift from earned income (money received from one’s labors) to unearned income (money received from one’s earnings on owned assets).

⁶ Within this context, we include all savings plan type accounts of a “defined contribution” nature; e.g. employer contributed assets as well as employee contributed assets that were not taxed at the time of contribution as taxation was deferred under various provisions of IRC §§401-424. As always, there is an exception, that being ROTH IRAs which are separately discussed due to their unique characteristics.

⁷ IRC §72(t)(2)(D).

- §72(t)(2)(A)(ii) Death
- §72(t)(2)(A)(iii) Disability
- §72(t)(2)(A)(iv) Substantially Equal Periodic Payments
- §72(t)(2)(A)(v) Separation of Service at Age 55

These five code subsections deal very specifically with how a taxpayer (or his or her estate) may commence withdrawals from their deferred asset accounts and avoid the application of the 10% surtax on those distributions.

Within this text, you will find issues and solutions that the general public, professional accountants and tax attorneys seldom confront. Further, due to a general absence of concise and practical information on this subject, many professionals periodically find themselves in a “reinvent the wheel” mode. Unfortunately, every time a wheel is reinvented, it tends to look a little different than the last time --- sometimes a little better and sometimes a little worse. This is a dangerous environment for “re-invention” in that, as we will discuss in depth later, making a mistake in theory or practice in this area can be extremely costly. Taxpayers are faced with taxation principles and issues that are not easy to understand and at the same time are becoming more popular. Further, implementation of SEPPs, or any of the other exceptions, is almost always a one way transaction; i.e. once a distribution or series of distributions have been made they are irrevocable and generally can not be replaced or corrected. As a result, a mistake will, more often than not, invoke IRC §72(t)(4) resulting in the 10% surtax with no methods available to correct the mistake on the part of the taxpayer.

The scope of this text covers a variety of what we collectively call “deferred accounts”. This includes all forms of §401(a), §403(b) and §401(k) plans as well as virtually all IRA types, SEPs and SIMPLEs. §401(a) and §403(b) plans can be either defined benefit or defined contribution plans. This text only deals with defined contribution plans and accounts⁸. Frequently, we will use the term “IRA” in an example. The reader should assume that the example applies equally to all types of deferred accounts unless there is a notation to the contrary.

The audience for this text is primarily twofold: individual taxpayers and professionals. More and more individuals are deciding to independently work through the financial issues of early retirement and thus the need to make withdrawals from their deferred accounts before age 59½. Additionally, financial advisors, professional accountants and tax attorneys have no source to go to when a client presents a situation requiring the implementation of §72(t) issues. In both instances, this text should answer almost all of your questions. However, as is needless to say, it is always possible for a client to present a set of facts & circumstances that will cause the answer to become unclear. Whenever this occurs, feel free to drop the author a note at themarblegroup@wispertel.net.

⁸ Defined benefit plan payments and annuities are ineligible for treatment under IRC §72(t). Instead, these plan types are handled by IRC §72(q)(2) and are outside the scope of this text. However, as a general comment, almost all of the exceptions found in §72(t) are repeated in §72(q) in order to afford the same or similar tax treatment to those taxpayers taking distributions from defined benefit plans.

We have attempted to make this text as thorough as possible. Unfortunately, most of the authority written on IRC §72(t) is spread over a variety of document types and locations --- many of which are unfamiliar to the average taxpayer. As a result, whenever possible, we have included the literal text, tables and other computations in the appendices⁹. Finally, we have made every attempt to explain the relevant theory and then bring that theory down to the practical level such that all readers should be comfortable with the basic concepts as well as the computational nuances.

Ninety-nine percent of all published literature on “deferred accounts” is either persuasive in nature ---- meaning that its focus is on why you should have an IRA or why you should contribute to your employer sponsored 401(k) plan; or it is focused on how you should manage these deferred assets during their accumulation years; e.g. should you buy stocks, bonds, mutual funds, etc. To the best of this author’s knowledge, there is no other comprehensive literature or writing available on getting your money out; particularly on getting your money out early. That’s what this text is all about.

The author is the first admit that an in-depth discussion on IRC §72(t) is, on a scale of 1 to 10; a 13 in the dry reading department. As a result, we have occasionally inserted some humor; mostly so everyone can stay awake. On the other hand, humor can be dangerous, as some one can always be offended. We mean no offense, malice or harm in this regard.

SEPP OBJECTIVES

Admittedly most of the following text is tax oriented, more specifically designed to avoid the 10% surtax on early distributions. However, we should back up for a moment and ask: “Why design a SEPP program; what objectives should it meet?”. In this regard, the author would like to suggest three, sometimes competing or conflicting objectives:

- Design a SEPP program that meets both current period and future period personal cash flow needs. Meeting cash flow needs implies obtaining some information:
 - What are my current living expenses that I need to replace?
 - What current (or future period) expenses will vanish and what new expenses will appear? In this category there are three expenses that are important to discuss:
 - ◆ Most taxpayers commencing SEPPs will realize a 7.65% decrease in expense

⁹ Even though private letter rulings, PLRs, are frequently footnoted throughout the guide, we have not included the full text of those PLRs as each is typically 6 to 12 pages in length. Any reader can acquire the full text if needed or desired by visiting www.irs.gov or using any of several proprietary search engine / databases such as: CCH, BNA, RIA, etc.

on their first \$87,900¹⁰ of withdrawals or \$6,724.35¹¹. This occurs because SEPP distributions are not subject to FICA / Medicare tax whereas virtually all wages and earnings from self-employment are.

- ◆ Medical insurance is a virtual necessity and unfortunately becoming ever more expensive. Some taxpayers will be fortunate & be offered paid or materially subsidized medical insurance coverages to age 65 by their employers. Other taxpayers will not be so fortunate and will be forced into the independent insurance market seeking to purchase coverage from retirement age until Medicare takes over at age 65. To put this issue in perspective, let's assume a married 50 year old with a similar aged spouse who might currently have an employer provided medical policy that could easily cost \$500 per month. This individual needs to purchase 15 years of medical insurance; but not at \$500 per month. Unfortunately, every year the insurance premium is going to rise between 15% and 25% caused by increased medical provider expenses as well as aging; e.g. a 55 year old uses some materially higher percentage of medical services as does a 50 year old. As a result, the net present value of 15 years of medical coverage can easily approximate \$250,000. How does this amount affect your total financial picture? Have you shopped for this insurance and received some quotations?

- ◆ Money to support others. In this category there are two main groups: parents and the potential for elder care expenses and children (college, disability, home purchase, etc.). And let's not forget the nieces, nephews and the wayward brother-in-law. Further, this area of expenses can be a "wild card". Today, a taxpayer may have no expectant needs in this area. However, 36 months from now may look materially different. As a result, throughout this guide, we will repeatedly focus and re-enforce the need to maintain future period flexibility in order to handle those emergencies without undo tax consequences.

In summary, a concise, multi-year cash flow plan is absolutely critical as one of the prime ingredients to a successful SEPP plan. As we will learn a bit later, SEPPs tend to be pretty much fixed in nature (at least to age 59 ½ or 5 years, whichever occurs later); however, life and its attendant expenses

¹⁰ \$87,900 is the FICA wage base for 2004; the last published amount. This limit is inflation indexed such that it will have a tendency to rise between \$1000 and \$3000 per year going forward.

¹¹ This savings can grow materially higher for a self-employed taxpayer with \$100,000 of income. In this case, the savings would be in the neighborhood of \$13,500. Refer to Schedule SE for the specific computations.

tend to be somewhat more volatile. As a result, it is necessary to build as many of these expense variations into the SEPP plan up-front in order to avoid costly short-falls in later years.

- Design a SEPP program that meets IRS standards. This is what the majority of this text is all about; however, it is often surprisingly the easiest of the three objectives to meet. In other cases, it may become the limiting factor which will require some rethinking of one's cash flow needs.
- Design a SEPP program for life. Or maybe not? There are any number of published "survivability studies" that fundamentally pose one question: "Will my assets survive until after my death or will my assets deplete themselves before my death?¹²". All of these studies disagree when asked the question: "Is a 4.25% withdrawal rate versus 4.75% the safe rate?". All of the studies agree that a safe withdrawal rate is some number that does not exceed 5% for a 50 to 55 year old with a remaining life expectancy in excess of 30 years. Should one then implement a SEPP program at age 50 that is designed to withdraw 8% of the assets for a minimum of the next ten years? Maybe, maybe not. In this regard, there seems to be two fundamental types of taxpayers facing this question.
 - Taxpayer #1 has an IRA which essentially represents all of his or her assets and will therefore be depending on those assets to last a lifetime. This taxpayer should therefore not launch a SEPP program at an 8% withdrawal rate as the survivability of the portfolio is somewhere in the 50% to 70% range; e.g. said another way, 1/3rd to 1/2 of the time, this taxpayer will be living and destitute sometime in his or her later years.
 - Taxpayer #2 has a similar IRA and is similarly aged. However, this taxpayer can expect and rely upon receiving a periodic pension commencing at age 60 such that he or she needs to withdraw 7% for the next 10 years at which time the IRA distributions can drop to 3.5% when the pension commences. Similarly, a parent or relative may provide a material inheritance in the not too distant future. As a result, taxpayer #2 is not designing a SEPP program for a lifetime; instead he or she is designing a limited term cash flow plan specifically designed to last 6, 8 or 10 years at the end of which the program will be materially modified and reduced. This taxpayer can afford to design a SEPP program at a 7% or 8% withdrawal rate because of the materially shorter time frame involved.

In summary, SEPP objectives are three-fold and are often in conflict with each other with any of the three potentially becoming the limiting or constraining objective. Taxpayers should look long and hard at all three objectives and create a SEPP plan that satisfies all three.

¹² This poses a very serious question of estate planning on the one hand and, on the other hand, perusing the classified's at age 78 for the minimum wage jobs at the fast food restaurant of your choice.

THE FOURTH EDITION

This is the 4th edition of the text. The 1st edition was published in September, 2000 and the 2nd edition was published in October, 2001. The 2nd edition was an expansion of the 1st edition as well as a topical expansion to cover some related topics such as ROTH IRAs and net unrealized appreciation of employer securities. The 3rd edition was a complete re-write due to the issuance of Revenue Ruling 2002-62. This 4th edition covers some new areas including: changes to the law from January, 2003 to current; expanded explanations of improper transactions; interaction between traditional IRAs and Roth IRAs; and, new computational methods. As a result, anyone in possession of a 1st through 3rd edition copy should destroy it as many of the tactical implementation rules identified in these earlier editions have now been overruled.

DISCLAIMER

In a way, it is unfortunate that books of this nature require disclaimers, but such is today's legal environment. We have made every effort to be accurate and believe that to be case as of November, 2004. Unfortunately, the IRC and related documents of authority are ever-changing. As a result, in some small fashion, this text has a high probability of becoming out-of-date within several months to a year. As a result, we can offer no prospective promises regarding accuracy beyond the date of publication. Further, purchase or other acquisition of a copy of this text does not create any type of client-professional relationship upon which a client may typically rely. Recognizing that this does not really help the reader, we suggest that serious readers intent on implementing one or more of the strategies outlined in this text should confirm to themselves that they are in fact dealing with the most current set of facts and applicable law. The easiest way to do this is to hire the expertise of a tax accountant or tax attorney who is conversant on these topics.

Lastly, just a couple of points about footnotes. Generally, the reader will find two types of footnotes throughout the text: one, specific citations to pertinent sections of the Internal Revenue Code, and two, more explanatory comments and / or author opinion on the subject matter at hand. If you are a tax accountant or lawyer, you will want to read all of the footnotes, particularly the first group, as they will provide you with a quick guide to get directly to the source authorities such that you can form your own opinions and interpretations. General interest readers can probably skip the citation footnotes (why would you care) and focus more on the explanatory and opinion oriented footnotes.

FORMAT

We have intentionally published this guide in 8 ½" x 11" format for several reasons. First, because it was a lot easier and less expensive for the author to publish in this format. Secondly, if we reduced the size to the more typical 6" x 9" format, the length of text doubles or triples and then everyone would have difficulty reproducing critical sections for their use. Lastly, we like the idea of a loose-leaf, ring-bound document from a reader's perspective; it automatically provides over 100 pages for note taking

and question asking. Implicitly, the reader's notes, on the flip side, should start with: "Does this mean I can do.....?" If you do not find the answer to your question within a couple of pages, please call or write to us.

BIOGRAPHICAL INFORMATION

William J. Stecker, (Bill), earned his bachelor's degree in Finance & Applied Mathematics in 1971 and a Masters of Science in Accounting from DePaul University (Chicago, Illinois) in 1983. He is a Certified Public Accountant since 1980 and a member of the American Institute of Certified Public Accountants as well as a member of the Illinois and Colorado state societies. Bill has spent over 30 years in accounting, finance and related fields. Further, he has particular in-depth knowledge on this subject, having made multiple and successful private letter ruling requests and determination letter requests to the Assistant General Counsel's Office of the Internal Revenue Service. Bill and his wife Mary own The Marble Group, Ltd., an accounting, tax and financial consulting group based in Colorado. Bill devotes most of his time to tax issues, specializing in retirement plan and participant issues --- primarily §72 and §§401-424 of the IRC. Bill is available for individual client representations and can be reached at: The Marble Group, Ltd., 30671 Bearcat Trail, Conifer, Colorado 80433 or themarblegroup@wispertel.net.

CHAPTER 1 --- CURRENT LAW

In this chapter we present the currently available resources that offer guidance on IRA withdrawals that are not subject to penalties. When aggregated together, these sources create something of a rule book. To help clarify the technical passages, we have added a brief explanation of each citation. Further, this chapter will discuss all 12 exceptions to the surtax and conclude with an introduction to substantially equal periodic payments, SEPPs, exception #4.

THE INTERNAL REVENUE CODE

We necessarily start with the Internal Revenue Code itself which imposes a 10% surtax on all distributions¹³ from deferred accounts:

IRC §72(t)(1) IMPOSITION OF ADDITIONAL TAX.--If any taxpayer receives any amount from a qualified retirement plan (as defined in §4974(c)), 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 several important points in this passage. First, is that the 10% tax is always imposed on any and all retirement plan distributions. Second, the 10% surtax is only imposed on amounts that are includible in the taxpayer's gross income; therefore distributions that are not includible in gross income are neither taxed nor surtaxed¹⁴. Fortunately, immediately following IRC §72(t)(1), IRC §72(t)(2) launches into a variety of exceptions to the general rule. It is important to remember that this is one of those code sections that was intentionally drafted in reverse; e.g. the 10% surtax always applies unless the taxpayer fully meets one or more of the exceptions identified in §72(t)(2). As a result, if the taxpayer does not fully satisfy an exception, then the 10% surtax is re-applied by the IRS without any need for further statutory action.

EXCEPTION #1 AGE 59 ½¹⁵

The best known exception is achieved by attaining age 59 ½. This exception would appear, on its face, to be rather easy to apply, e.g. make a withdrawal after you are 59 ½ and you will not be subject to the 10% surtax. However, there are three very specific rules which apply:

¹³ IRC §72(t)(1).

¹⁴ As we will learn later, this concept of "includible in gross income" will apply in two situations: one, taxpayers taking distributions from §401(k) plans that include after-tax (meaning already taxed) contributions; two: regular IRAs and ROTH IRAs which similarly may contain after-tax amounts.

¹⁵ IRC §72(t)(2)(A)(i).

- The IRS is required to make a literal age interpretation here because it is the IRC which specifically says, “made on a day on or after the date on which the employee attains the age of 59 ½.” So when do you have your 59th and ½ birthday? Exactly 183 days after your 59th birthday. As an example, if your birthday is April 26, 1946, your 59 ½ birthday is October 26, 2005. A withdrawal made on this date or later will be fine; a withdrawal made on October 25th or earlier will cause the 10% surtax to apply¹⁶.
- As we will learn later, if you are making substantially equal periodic payment distributions subject to IRC §72(t)(2)(A)(iv), the use of exception #1 may be held in abeyance for some amount of time until all of the requirements of exception #4 are fully satisfied¹⁷.
- All IRAs of all types (as well as all other deferred accounts) are always individually owned. As a result, if two individuals are married and only one is over the age of 59 ½; then, only that individual is eligible for this exception.

EXCEPTION #2 DEATH¹⁸

Death, although never really a desirable outcome, is usually a fairly straight-forward event; some one either is or is not deceased & just about every jurisdiction on the planet is required to issue a death certificate when this unfortunate event occurs. Thus, the test is simple: presence of a signed death certificate (irrespective of cause) passes; anything else does not. This is as good a time as any to raise two important but unrelated topics: one, the IRC versus the IRS, and two, the concept of playing audit lottery:

- By the time the reader reaches the end of this text, it will become apparent that there is often considerable latitude in the implementation of these exceptions. Then, in another circumstance it will appear to be as if the rules switch around and become unduly harsh and restrictive; e.g. why measure one’s 59th and ½ birthday to the day; shouldn’t attaining age 59 ½ sometime in the taxable year be sufficient? The reason for this lies in determining who or what is the prevailing authority on the question or issue at hand. When language is embodied in the Internal Revenue Code, then the Internal Revenue Service and the courts

¹⁶ Several other sections of the IRC and this text will employ the concept of a taxpayer’s “highest attained age” within a particular calendar / tax year. This is not one of those situations. Instead, the IRS is required to and does measure to the day.

¹⁷ By way of example, assume a taxpayer, aged 57, commenced a SEPP plan and then materially altered the annual distributions at age 60. The distributions made from age 57 to age 59 ½ would be retroactively surtaxed at 10% plus interest because the taxpayer would not have satisfied the “5 year” rule. The distributions made on or after age 59 ½ would not be surtaxed as IRC §72(t)(2)(A)(i) would apply.

¹⁸ IRC §72(t)(2)(A)(ii).

have no alternative but to take a very literal interpretation of the law¹⁹. Conversely, there are many circumstances where the IRC is vague or may embody language like, “based on the regulations as issued by the Commissioner.” In this later case, decision-making authority is actually transferred from Congress to the IRS on the belief that the IRS is better at examining the details of a situation and is better qualified to issue appropriate regulations and opinions. In these later cases, we will find considerable additional flexibilities afforded to taxpayers.

- Everyone would like to win the Powerball lottery. However, it is said that this is about as likely as being struck by lightning three times on the same day. However, you may wish for the lightning instead of winning the IRS lottery. Should your social security number magically turn up²⁰, it is very important to know which lottery you have just entered.

In the arena of auditable issues on IRC §72(t) there are really two different environments: the IRC lottery and the IRS lottery. In the same context as above, if you are audited and the central issue to be resolved lies in an interpretation of the IRC as drafted by Congress, **YOU WILL LOSE!** The IRS as well as tax courts and federal district courts will take a literal and restrictive construct of the IRC language. In short, there is zero maneuvering room. Conversely, if the central issue lies in the interpretation of the IRC through the IRS’s issuance of regulations or rulings, you may then stand a chance, modestly greater than zero of prevailing; however, that chance still remains relatively small.

Sometimes the temptation to venture into “audit land and the gray areas of the IRC” may appear to be a wise business decision. This is not one of them. As we will discuss later in the text, the body of knowledge and authority is not in the taxpayer’s favor. Further, in this particular section of tax law, there are virtually no corrective measures available to the taxpayer when the IRS prevails. There is no way, or only very limited ways, to put back the improper distributions and amend your tax returns. Lastly, there isn’t even any negotiating room in the computation of the penalties and statutory interest due. In summary, IRC §72(t) is not the place to push the envelope as the downside risks are substantial and almost always, non-negotiable.

¹⁹ Think of it this way. Congress takes a fairly dim view of affairs when an executive branch employee, even if he is the Secretary of the Treasury, decides that something in the Internal Revenue Code means something different than what Congress wrote.

²⁰ There is absolutely no evidence that taking early distributions from your deferred-asset accounts in any way influences or increases your likelihood of an audit. However, should you be audited, there is a 100% probability that your SEPP withdrawals will be closely examined to insure full compliance.

EXCEPTION #3 DISABILITY²¹

The full text of exception #3 says, “attributable to the employee’s being disabled within the meaning of subsection (m)(7).” “Attributable” means that in order to use this exception, you, personally, must be physically and/or mentally disabled according to the following definition:

“...an individual shall be considered to be disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued or indefinite duration. An individual shall not be considered to be disabled unless he furnishes proof of the existence thereof in such form and manner as the Secretary may require.”

IRC §72(m)(7)

What does the preceding mean? First, with certainty, if you choose to use this exception and are subsequently audited, you will be required to present external proof and evidence that you are disabled. Second, the IRS has issued a fairly in-depth regulation on this subject. It says in part:

*“In determining whether an individual’s impairment makes him unable to engage in **any substantial gainful activity** [emphasis added], primary consideration shall be given to the nature and severity of his impairment. Consideration shall also be given to other factors such as the individual’s education, training, and work experience. The substantial gainful activity to which section (m)(7) refers is the activity, or comparable activity, in which the individual customarily engaged prior to the arising of the disability...”*

IRC Reg. §1.72-17A(f)

The above Code and regulation language imply several tests or hurdles that must both be met or exceeded in order to qualify for this exception. They are:

- Effectively, the **disability must be total** as opposed to partial. As an example, some one may be disabled in all outward appearances; however, if that person were capable of (irrespective of whether he does or not) returning to work on a part-time basis performing his or her pre-disability job function; then that person would not be considered disabled under this definition.
- The disability is always measured in context to the individual’s pre-disability occupation.

²¹

IRC §72(t)(2)(A)(iii).

As an example, two brothers are in a vehicular accident resulting in both brothers becoming paraplegic & both brothers fully recover but for the use of their legs. One brother was a professional football player & the other was a surgeon. The former is disabled, the later is not. At one time, cancer was considered, almost automatically, to be a total and permanent disability. With the advent of new drugs & surgical procedures this is no longer the case. As a result, at least over some moderate to lengthy period of time, the concept of “disability” becomes somewhat of a moving target.

The IRS will consider any and all external evidence the taxpayer produces but is not necessarily bound or obligated to honor that evidence in making its determination. Such evidence usually will include physician statements, employer statements, proof that you are already collecting private disability insurance, and Social Security disability proceeds --- Social Security being the most persuasive evidence. Further, being disabled has been classified as a “facts and circumstances” test by the IRS, accordingly, they will not rule in advance on this issue for individual taxpayers, nor is there any list existing that automatically creates disabled status. As a result, this author believes that using this exception is a fairly dangerous strategy unless the disability is beyond a shadow of a doubt. With any lesser disability, a taxpayer is well advised to seek the professional opinion of an attorney who specializes in disability matters.

EXCEPTION #5 SEPARATION OF SERVICE AT AGE 55²²

Wait a minute. What happened to exception #4? Number 4 --- substantially equal periodic payments --- is by far, the most difficult of the process / multi-year exceptions to understand and is the most difficult of all of the exceptions to implement correctly. As a result, we are going to skip #4 for the moment and finish the discussion of the remaining exceptions first.

In most cases in this text, we treat “deferred plan assets” and IRAs as being the same thing and accordingly receive the same treatment as well as use of the exceptions under IRC §72(t). However, this exception #5 is one of the exceptions to the general rule. Exception #5 provides an ability for a separated employee to commence withdrawals provided he is 55 or older when separated from the employer who is the plan sponsor from which the now separated employee wishes to make withdrawals. Unfortunately, IRC §72(t)(3)(A) says in part that §72(t)(2)(A)(v) “does not apply to distributions from an individual retirement plan.”²³ This simple sentence effectively forces a split between qualified plan assets and IRA assets and makes subsection (v) only available to the former and disallows the same treatment for IRA assets. Notice 87-13 provides a further amplification of how to interpret IRC §72(t)(2)(A)(v) by saying:

²² IRC §72(t)(2)(A)(v).

²³ Why this distinction between plan assets and IRA assets (definitionally not a qualified plan) remains a mystery.

“Section 72(t) (as added by TRA ‘86) applies an additional tax equal to 10 percent of the portion of any “early distribution” from a qualified plan...that is includible in the taxpayer’s gross income...A distribution to an employee from a qualified plan will be treated as within §72(t)(2)(A)(v) if (I) it is made after the employee has separated from service for the employer maintaining the plan and (ii) such separation from service occurred during or after the calendar year in which the employee attained age 55.”

IRC Notice 87-13

Finally some reasonably clear language. As we will learn later, SEPPs are by their nature very restrictive. Here, we can skip all of the SEPP rules if the taxpayer can comply with the rules enumerated in Notice 87-13. What are those rules?

- The taxpayer must terminate from his or her employer in the same tax year as he or she attains the age of 55 or older. This is not the same as being 55 or older when you quit. Instead, one need only reach age 55 anytime in the same calendar year, even if attaining age 55 occurs six months; or 364 days after termination. Thus, the theoretical minimum age exists of 54 years and 2 days. If your birthday is December 31st, you could resign on January 2nd of the year you turn 55 and be eligible.
- The assets withdrawn must be withdrawn directly from the plan sponsored by the employer from which the employee has just terminated. **This is critical.** Further, there are three subsidiary issues of equal importance:
 - If the taxpayer terminates employment with the employer / plan sponsor and immediately rolls the plan assets into a rollover IRA; the IRA assets, though they did originate from the qualified plan, are now ineligible for treatment under §72(t)(2)(A)(v). The assets must absolutely remain in the plan. Thus, as a caution, taxpayers should resist the sales pitches from various financial advocates that employees should quickly rollover their plan assets into IRAs in order to take advantage of all the investment vehicles that are available through an IRA and might not be available inside the qualified plan. If you are 35, go ahead and do a rollover; if you are 54 ½, this can be a disaster if not analyzed carefully in advance.
 - Working for a single employer for thirty or more years is pretty much an event of the past. As a result, it is not uncommon for a taxpayer to have two, three or more §401(k) plans and/or related conduit IRA accounts²⁴. Further, it tends to be the oldest accounts that are the largest simply because they have had the longest amount

²⁴

We use the term “conduit IRA” account here to mean a temporary IRA account housing the assets of a prior employer’s qualified plan, usually waiting to become eligible to be rolled into a new employer’s qualified plan.

of time to appreciate in value. Nonetheless, Notice 87-13 tells us that we can only make withdrawals from the plan account from the employer from which the employee just separated. How do we get at the plan assets from prior employers? The easiest solution is to perform a series of rollovers by rolling the assets forward from either prior employer plans or conduit IRAs into your current employer's plan. Further, these rollovers invariably need to be performed before you terminate, as rollovers are often prohibited for terminated plan participants. On its face, this all appears to be illogical²⁵. How can it make any difference if all of the money is in the current plan versus spread out over three or four plans from different employers? We all know it doesn't make a real difference; however, this is one of those situations where form does govern over substance.

- The third requirement to implement this exception is not IRS related; rather, one needs a cooperative plan administrator. The essence of exception #5 is to be able to make periodic distributions of differing amounts whenever you want & not pay the 10% surtax. This necessarily means that your current plan & plan administrator must support periodic distributions --- not all plans allow this.

In summary, taxpayers who are 55 (or will be 55 in the current tax year) and are separating from their employer²⁶ should pause and think very carefully about this issue. There is no clear-cut obvious or winning decision here as there are pros and cons to each decision path. The biggest advantage is that the taxpayer need not pay any attention to SEPPs and their rules and instead can withdraw any amount at any time. The biggest disadvantage is that most §401(k) plans limit investment choices (often to mutual funds only) which may not be to one's liking. As a result, any taxpayer in the 54 ½ to 59 ½ age window leaving their employer should seek professional help before automatically rolling over §401(k) assets into an IRA.

EXCEPTIONS #6 THROUGH #12

These exceptions are the transaction specific exceptions in that they define specific situations where distributions are not surtaxed and tend to be fairly limited in scope and / or dollar amount.

- **#6 §404(k) Stock Dividends²⁷**. This will likely occur whenever you are a member of an

²⁵ Spock, where are you when we really need you?

²⁶ In today's economic environment, many taxpayers are being offered "early retirement" packages from their employers. Often, an employer will be willing to structure severance pay for an early retiree such that the periodic severance pay, and therefore employment period, extends into the first few weeks of January of the tax year in which the employee will attain age 55 thus making this exception a viable planning alternative.

²⁷ IRC §72(t)(2)(A)(vi).

older §401(a) plan in which the plan sponsor / employer contributes employer stock to the plan. Further, the original plan was drafted in a manner that requires that when the corporation declares a dividend, that dividend must be paid on the securities held in the plan. Strangely enough, the actual dividend dollars cannot be paid into the plan itself but must instead be paid directly to the plan participants. In short, almost all readers need not concern themselves about this exception. If you are subject to it, your plan administrator will let you know how to declare the dividends received as income and specifically how to avoid the 10% surtax.

- **#7 Tax Levies²⁸**. Should you be unfortunate enough to be subjected to a federal tax levy²⁹, Congress has graciously determined that the 10% surtax will not be due. However, there are several catches: one, regular federal income tax will still be due upon the distribution of the IRA; two, the distribution of the IRA must be pursuant to a court ordered levy and the actual distribution from the IRA must be made directly to the IRS. Conversely, if the IRS sends you a deficiency notice or otherwise obtains a judgement against you and you voluntarily cash the IRA to satisfy the deficiency or judgement, this exception will not apply.
- **#8 Medical Expenses³⁰**. You may make distributions from your IRA up to the amount of your qualifying medical expenses³¹ and escape the payment of the 10% surtax remembering that regular federal income taxes will still be due. A little higher math is involved in that you may only withdraw monies from the IRA penalty-free to the extent that your qualifying medical expenses exceed 7 ½ % of your adjusted gross income. Further, a distribution to cover these medical expenses³² also increases your AGI. Assume your AGI before the distribution is \$100,000; you have \$22,500 of medical expense of which \$15,000 is eligible remembering that the first 7½% or \$7,500 is ineligible. You might withdraw \$15,000 from your IRA thinking it will all escape the 10% penalty. Unfortunately, the \$15,000 is added to your AGI resulting in \$8,625 of ineligible medical expense. Thus, \$13,875 is protected and \$1,125 is not resulting in a “hidden” 10% penalty of \$112.50.

²⁸ IRC §72(t)(2)(A)(vii).

²⁹ This is tantamount to the IRS performing asset seizure, where they will typically take your residence, your cars, your jewelry, and, by the way, your IRAs as well, all pursuant to a court order.

³⁰ IRC §72(t)(2)(B).

³¹ See IRC §213; typically the same medical expenses you would place on Schedule A --- Itemized Deductions.

³² Further, the U.S. Tax Court has just recently ruled that the distribution from the IRA and the payment of the medical expenses must occur within the same tax year. See Jeanette Kimball v. Commissioner; T.C. Summ. Opinion 2004-2 #16640-02S.

- **#9 Qualified Domestic Relations Orders³³**, (QDROs). Only slightly more fun than a tax levy, a QDRO is a court order signed by a judge, typically as a result of a divorce proceeding. With respect to your IRA, the judge can conceivably sign two different types of QDROs:
 - The judge may sign an order requiring the division of your IRA into two separate IRAs; typically one for you and the another for your ex-spouse. In this instance, an asset is being divided up where the essential character of the two new IRAs remains unchanged; just the names on the accounts have been altered. This “divide the asset” style QDRO is a non-taxable event as governed by IRC §414(p).
 - The judge may also sign an order requiring a periodic payment stream from your qualified plan³⁴ thus creating a taxable event to one or more of the ordered payees ---- typically to the ex-spouse or children. In this case a taxable event has occurred requiring that income tax be paid on the amounts distributed each year. Fortunately, the 10% surtax is excused regardless of your age.
- **#10 Payment of Health Insurance Premiums While Unemployed³⁵**. If you have been or were unemployed for twelve or more weeks, you may make withdrawals from your IRA up to the amount of your health insurance premiums for the period during which you were unemployed.
- **#11 Higher Education³⁶**. Generally speaking, distributions from your IRA³⁷ can be made to pay for post-secondary “qualifying” educational expenses for yourself, your spouse and your children. Qualifying expenses³⁸ include: tuition, fees, books, supplies & equipment required for attendance at an eligible educational institution. Further, room & board become qualifying expenses when the student is at least a ½ time student. These permissible withdrawals are reduced by any Hope scholarship credits or Lifetime learning credits that are in effect.

³³ IRC §72(t)(2)(C).

³⁴ Please note the change in language here to “qualified plan”. IRAs are not eligible for this exception.

³⁵ IRC §72(t)(2)(D).

³⁶ IRC §72(t)(2)(E).

³⁷ In another strange twist, this exception is only available to IRAs and unavailable to other qualified plan assets.

³⁸ IRC §529(e)(3).

- **#12 First Time Home Purchase**³⁹. You may withdraw up to \$10,000, per lifetime, from your IRA⁴⁰ to purchase a principal residence --- provided that you have not owned a home in the last 24 months. The specific rules are fairly sticky here; as a result, the author suggests you seek professional assistance to insure that you correctly qualify when attempting to use this exception.

A word of caution is appropriate here. Exceptions #6 through #12 all vary in complexity, each with its own set of detailed qualifying rules. The proceeding has been a brief overview simply to let the readers know that the exceptions exist and may be used when the proper conditions present themselves. Exceptions can generally be used independent of one another; however, there is usually one right way and several wrong ways to implement any of the exceptions. Although some of the exceptions appear to be fairly generous, particularly for circumstantial distress, it is advisable to seek professional assistance when attempting to implement any of these exceptions. An exception, incorrectly implemented will cause the 10% surtax to be imposed and there is generally no facility to correct mistakes once they have occurred.

EXCEPTION #4 SUBSTANTIALLY EQUAL PERIODIC PAYMENTS

IRC §72(t)(2)(A)(iv) introduces us to a lesser known and the least understood exception --- the concept of a “substantially equal periodic payment” (SEPP)⁴¹. Understanding a SEPP necessarily starts with the IRC itself:

“Part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of such employee and his designated beneficiary.”

IRC §72(t)(2)(A)(iv)

We can learn a lot about SEPPs from just this one sentence. It is actually easier to take the term “substantially equal periodic payments” and deal with each word in reverse order:

³⁹ IRC §72(t)(2)(F).

⁴⁰ Same as footnote 35.

⁴¹ Conversationally, many people may say, “I have a SEPP-IRA, or I have a 72T plan or a 72T-IRA, or I am taking 72T or SEPP distributions from my IRA. Invariably, these are all short-hand expressions for distributions made pursuant to IRC §72(t)(2)(A)(iv).

- PAYMENTS in this case means a dollar⁴² withdrawal from the deferred account. Further, because of the plural, we can infer that there will need to be more than one payment.
- PERIODIC implies that each of the multiple payments will occur over some set of defined intervals. Immediately following, we find the language: “not less frequently than annually.” As a result, we know the outside limit with certainty --- a minimum of once a year. However, there is no guidance about more frequently than annually. As we will learn later, monthly and quarterly distributions are just fine as well.
- EQUAL implies that the withdrawals from the deferred account will be of equal or the same dollar amount.
- SUBSTANTIALLY is potentially the most interesting word in the sentence. It becomes a modifier to the word “equal”. If Congress had intended for the payments to be literally equal, it would not have used the adjective “substantially”. As a result, we now have “sort of” or “almost” equal payments because we do not yet know how to interpret the word “substantially”; e.g. where is the dividing line between substantially equal and unequal.
- MADE FOR THE LIFE effectively creates a multi-year time span that is defined as either the life expectancy of the employee⁴³ or the dual expectancies of the employee and his beneficiary. We don’t know what this number is yet. But we should expect it to be a large number.

rules: Next, we need to turn our attention to IRC §72(t)(4)(A) which provides some additional

“[If]...the series of payments under such paragraph are subsequently modified (other than by reason of death or disability)...before the close of the 5-year period beginning with the date of the first payment and after the employee attains age 59 ½, or ...before the employee attains age 59 ½, [then]... the taxpayer’s tax for the 1st taxable year in which such modification occurs shall increased by an amount...equal to the tax which...would have been imposed, plus interest for the deferral period.”

IRC §72(t)(4)(A)

⁴² 99% of all readers will be contemplating making cash distributions from their IRAs. “In kind” distributions are also permitted; however, when this occurs, the asset distributed “in kind” must be valued at fair market value at the time of distribution. Needless-to-say, the IRS tends to look closer at “in kind” distributions.

⁴³ The IRC frequently uses the term “employee” in the context of a participant in a qualified plan. Unless otherwise noted, the term “employee” and the term “owner” are synonymous.

Here lies the trap regarding all SEPP plans. The above essentially says that if you modify your SEPPs, for any reason other than death or disability, before the passage of at least a 5 year period and attaining age 59 ½, then the 10% surtax will be imposed on all of the distributions plus statutory interest. This is absolutely critical; so allow some re-emphasis. If a taxpayer modifies (read changes) the annual distributions before the passage of five years and attaining age 59 ½; then the 10% surtax, plus interest will due on ALL DISTRIBUTIONS; not just the “modified” distribution. By way of example, assume a taxpayer commences a SEPP plan in 1995 at age 50 distributing \$50,000 per year. In 2002, at age 57, the taxpayer dutifully distributes the \$50,000 and additionally distributes another \$10,000 from the same IRA for some other purpose. This is a modification! The additional taxes and interest due will be in the neighborhood of \$50,000 to \$60,000. In short, as we will learn through the remainder of this text, the single word “modified” is extremely important; e.g. a circumstance that we want to avoid at all costs.

We can now develop a working definition of SEPPs as follows: A series of payments or withdrawals from deferred account(s) that can either be exactly equal or potentially somewhat dissimilar, that occur annually or more frequently, and continue unmodified for a minimum time period of five years or until the taxpayer attains the age of 59 ½, whichever is greater. As a result, if we establish a payment stream that meets this definition, we should be able to do so and avoid the 10% surtax.

There are some other fairly obvious rules that come about through coordination with other code sections:

- The 10% surtax, if and when applied, only applies to that portion of the distribution that is otherwise includible in the gross income of the taxpayer. As an example, if one were to withdraw \$10,000 from an IRA and that \$10,000 was composed of \$8,000 of untaxed dollars and \$2,000 of after-tax dollars; then only the \$8,000 is includible in the taxpayer’s gross income; therefore the surtax would only be \$800, not \$1,000.
- In order to take distributions from a qualified plan, the employee must have separated service from the employer⁴⁴.
- Coordination between exceptions #1 and #4. From our discussion above, it is pretty clear than when a taxpayer, aged 50, commences SEPPs and then modifies⁴⁵ those payments before age 59 ½ then he will owe the 10% surtax plus interest on 100% of the distributions. What about a taxpayer, aged 57 who commences SEPPs and continues them to age 59 ½ and then modifies the SEPPs after age 59 ½? The taxpayer is over 59 ½ but has failed the 5-year rule as required by IRC §72(t)(4)(A). As a result, the distributions made after age 59 ½, even though a modification of the original SEPP plan are okay; however, the 10% surtax and interest is imposed on the 2 ½ years worth of distributions made during the time period when the taxpayer was aged 57 to 59 ½.

⁴⁴ IRC §72(t)(3)(B).

⁴⁵ A voluntary cessation of payments is considered a modification.

Virtually all of the remainder of this text is devoted to proper SEPP plan design and therefore avoidance of the 10% surtax. Unfortunately, regular income tax (always federal and sometimes state tax as well) is due. After all, the contributions, by employees and employers, as well as all of the earnings on those contributions have never been taxed. Thus, we tend to call all of these accounts and assets as “deferred asset accounts”, not “tax free” accounts. Taxation of these accounts has been deferred⁴⁶ (not eliminated or forgiven) during their accumulation years. Now that the taxpayer wants to commence withdrawals, the tax deferral period ends and Congress, through the arm of the Internal Revenue Service, is standing at your door ready to finally collect.

INTERNAL REVENUE SERVICE PUBLICATIONS

There are two IRS publications that are absolutely critical in the design of SEPP plans. They are:

- Publication 590. This is the IRS’s seminal text (approximately 80 pages in length) on IRAs. Everyone reading this text should have a copy of this publication. If you have not already done so, stop reading now, go to the www.irs.gov web site into the publications section, select Publication 590⁴⁷ and print it.
- Revenue Ruling 2002-62⁴⁸ is the current bible on SEPPs which became mandatorily effective on January 1, 2003⁴⁹. This ruling provides substantial details on allowable computational methods; “modification” escape mechanisms and life expectancy tables that are required to be used. In subsequent chapters we will literally tear this ruling apart, sometimes word-by-word, in order to discern all of the detailed rules on SEPP plan development.

⁴⁶ For those taxpayers who are participants in any kind of §401 plan with your employer; you might want to take a close look at your pay stub. You will notice that your contributions are not federally or state income taxed. However, those contribution dollars are taxed for FICA/Medicare (roughly 7.65% on the first \$87,900 of wages). As a result, when distributions occur in later years, the income tax becomes due but no FICA/Medicare taxes are due as these taxes were paid years ago when the contribution was made.

⁴⁷ Pub 590 is an Adobe Acrobat “pdf” file. As a result, you will need a copy of Adobe Acrobat Reader v4 or v5 in order to download and print this file. If you do not have a computer that is Internet enabled, call the IRS and request a copy of this publication by mail.

⁴⁸ Internal Revenue Bulletin 2002-42, 710; October 21, 2002. A complete copy of this ruling has been reproduced in the appendices of this text.

⁴⁹ Those readers with editions 1 or 2 of this text or with copies of Notice 89-25 should destroy them as the text itself and the Notice are no longer correct. The exception is any reader who has enacted a SEPP plan on or prior to December 31, 2002. Those readers should retain their old version of this text & Notice 89-25 as historical authority that represents the correct authority when they enacted their SEPP plan.

TAX COURT CASES

Where else can we look for authority on SEPPs? The United States Tax Court and District Courts have heard and ruled on several cases pertaining to SEPP plans. There are several of direct importance:

- Arnold v. Commissioner⁵⁰. The real issue decided in this case was the precise definition of the phrase “...the 5-year period beginning with the date of the first payment...”⁵¹ The Arnold’s contended that “5-year period” meant five calendar tax years as they had taken five equal annual distributions in 12/89, 1990, 1991, 1992 and 1/93; thus spanning five tax years but only 38 calendar months. The Arnold’s then took an additional distribution later in November, 1993, after Mr. Arnold’s 59 ½ birthday contending that they had met the “5-year” rule. The Commissioner contended that a literal interpretation was appropriate in that any language referencing a “tax year” was absent in the IRC and that therefore a “5-year period” that commenced with the first payment therefore defined a period from 12/89 through 12/94. The tax court agreed with the Commissioner thus determining that: “It is evident that the 5-year period in §72(t)(4) closes at the end of 5 [calendar] years from the date of the first distribution. It does not end on the date of the 5th annual distribution...”. Thus, the extra distribution in November, 1993 constituted a “modification” which therefore disallowed all the distributions from 12/89 through 1/93 and imposed the 10% surtax plus interest.

- Farley v. Commissioner⁵² was a pro se representation (in the author’s opinion, never a good idea when dealing with the IRS in Tax Court); where Farley attempted to persuade the court that 29% was a reasonable interest rate assumption. Even though the pertinent transactions all occurred prior to December 31, 2002; the court was not impressed ruling:
 - The tax court is NOT bound by the then prevailing Notice 89-25 and therefore by implication would neither be bound by Revenue Ruling 2002-62. In this case the Court emphasized the non-binding nature of Notice 89-25, but permitted the parties to proceed under mutual consent.

 - Notice 89-25 contained the language: “at an interest rate that does not exceed a reasonable interest rate on the date payments commence.” As a result, the court ruled that Farley had used a growth rate / interest rate assumption in the amortization method that was too high; specifically the Court said: “in contravention of the legislative purpose underlying IRC §72(t).”

⁵⁰ 111 TC 250; 1998 U. S. Tax Court. As mentioned earlier, here is case that hinged on an interpretation of the IRC; not an interpretation of an IRS opinion or publication. You can already guess the outcome.

⁵¹ IRC §72(t)(4)(A)(ii)(I).

⁵² T.C. Summ. Op. 2003-43 WL 1923472.

Needless-to-say, in this author's opinion, the 29% interest rate was pure fiction; e.g. simply that required rate of interest needed to mathematically support the annual distribution amounts taken by Farley based on his IRA balance and age. Neither the IRS nor the Tax Court were fooled.

Getting a little ahead of ourselves for a moment, Revenue Ruling 2002-62 now proscribes the use of an interest rate that does not exceed 120% of the mid-term applicable federal rate for either of the two months that proceed the 1st distribution. In today's environment, these rates tend to be in the 4% to 6% range; materially less than 29%. However, Revenue Ruling 2002-62 is a "safe harbor" ruling in the sense that it declares SEPP plans valid and not subject to the 10% surtax when all of the rules contained within the Ruling are followed. Conversely, it does not automatically invalidate SEPP plans that do not follow all the rules; instead a taxpayer who adopts a SEPP plan, not in 100% compliance with Revenue Ruling 2002-62, is left in "no man's land"; e.g. uncertain if that plan will or will not be subject to the 10% surtax. Thus, in addition to reading (and understanding) the IRC and related IRS pronouncements, we also need to take an in-depth look at private letter rulings.

PRIVATE LETTER RULINGS

What is a private letter ruling (PLR)? A PLR is essentially the making of law one taxpayer at a time. A taxpayer may make a PLR request to the Assistant General Counsel's Office of the IRS, essentially the IRS's internal legal department. During the period of 1988 through March, 2002, the IRS issued approximately 80 private letter rulings on pertinent §72(t) issues. Although "private", meaning for the use of the submitting taxpayer only, these PLRs are published⁵³ so that professionals can read them in order to gain a keener insight into the IRS's thinking on details as well as policy. Unfortunately, we face two hurdles or dilemmas when looking at PLRs:

- Every PLR issued starts with the language: "This document may not be used or cited as precedent. §6110(j)(3) of the Internal Revenue Code." Roughly translated, this means that we can not rely upon a PLR which was necessarily drafted with the submitting taxpayer's facts & circumstances in mind, as precedent for our own purposes. There are actually good reasons for this language: one, some other taxpayer went to the time & expense of obtaining the PLR; therefore it his & not ours for the taking. Secondly, and more importantly, PLRs are a response of law (or at least the IRS's position of law to which they are essentially bound) to a particular and fixed set of facts & circumstances from a single taxpayer. Rarely are circumstances identical and it would be much to easy for taxpayer #2 or taxpayer #156 to use taxpayer #1's PLR with a slightly modified fact set. Unfortunately, it can be that slight modification of facts that nullifies or reverses the essence of a PLR.

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A published PLR is done so in redacted form, meaning that names, dates, amounts, etc. are removed from the PLR in order to protect the privacy of the submitting taxpayer. In addition, a substantial portion of the detail facts & circumstances as submitted by the taxpayer may be deleted from the published ruling. Thus, PLRs are a valuable tool from a theory perspective only; and never from a facts & circumstances perspective.

A logical question to ask is why would we even bother to read PLRs if we can not use them? We read them for two reasons: one, the PLRs are intentionally published as a mechanism for outsiders to learn the thinking and leanings of the IRS on pertinent issues without the IRS being “legally bound” to others; e.g. a formalized way to provide a peek in the box; secondly, we can often find the same issue repeating itself through numerous PLRs where the issue is not related or tainted by specific taxpayer facts & circumstances. This then becomes a mechanism to extract the pertinent theory from a group of PLRs upon which we may rely. As we march through subsequent chapters of this text, you will find citations to groups of PLRs that are essentially a confirmation mechanism or affirmation of our basic thinking. In other areas there may be one or two PLRs indicating that possibilities exist on a certain issue. We will clearly point these out as they occur and differentiate between them.

- Beyond the above, we face an even greater challenge in the examination of PLRs. The 80 or so PLRs issued were all done so in reference to IRC §72(t) and Notice 89-25; the governing law from Spring, 1989 through December, 2002. The IRS issued Revenue Ruling 2002-62 in October, 2002 with a mandatory effective date of January 1, 2003 which explicitly overturns Notice 89-25. Do we therefore throw away all 80 of those PLRs because new law is now in effect? Yes, but! We discard all 80 rulings and then very carefully re-read all of them looking for ruling sets that meet two criteria:
 - One, the ruling, or group of rulings, was deciding an issue or interpretation of the Internal Revenue Code and not an interpretation of old Notice 89-25; remembering that Notice 89-25 has been overturned; however, IRC §72(t) survives as it has not been changed.
 - Two, the rulings at hand were deciding an issue outside the boundaries of both Notice 89-25 and Revenue Ruling 2002-62⁵⁴. Said another way, if a group of rulings discuss an issue that is important to the design of a SEPP program but the issue is not mentioned in either the Notice or the Ruling; then, that group of rulings likely survive even though the PLR publication dates precede October, 2002. Some examples are in order:
 - ◆ Multiple rulings in the 1990's approved the use of UP-1984 as a “specifically approved” mortality table from which various life expectancies could be computed. Revenue Ruling 2002-62 specifically says in part: “The life expectancy tables that can be used...are...” Here is a case where the new ruling is very specifically “on point”; therefore, commencing January 1,

⁵⁴

Both Notice 89-25 and Revenue Ruling 2002-62 are computational method, interest rate and mortality table oriented. Thus their scope is necessarily limited and does not cover a number of other ancillary issues which are nonetheless still important in the tactical planning of SEPP programs.

2003, the use of UP-1984 is prohibited irrespective of its prior approval.

- ◆ Other issues, such as the use of “stub periods”, launching of multiple SEPP programs and so forth are not mentioned, discussed or inferred in either the Notice or the Ruling. As a result, these tactical topics are outside the scope of both documents. In these cases we may, albeit carefully, rely upon PLRs that focus on these areas.

The issuance of Revenue Ruling 2002-62 has necessarily reduced the body of knowledge and law on the whole §72(t) issue. This is, in a way, unfortunate but necessary. As indicated earlier, we will sometimes go word-by-word through the new ruling to determine its true meaning. Further, the new revenue ruling is a major improvement, sometimes in flexibility; sometimes in detailed and fairly strict guidance; but, in all cases a major improvement over Notice 89-25 for which we will gladly trade away groups of old PLRs which are now overruled.

Because this issue of “qualified plan” versus IRAs can get complex; we have included the table following which highlights which exceptions can be used in conjunction with which account types:

Exception #	IRC Code §	Title	Qualified Plan	IRA
1	§72(t)(2)(A)(i)	Age 59 1/2	Yes	Yes
2	§72(t)(2)(A)(ii)	Death	Yes	Yes
3	§72(t)(2)(A)(iii)	Disability	Yes	Yes
4	§72(t)(2)(A)(iv)	SEPPs	Yes	Yes
5	§72(t)(2)(A)(v)	Separation of Service At 55	Yes	No
6	§72(t)(2)(A)(vi)	§404(k) Dividends	Yes	N/A
7	§72(t)(2)(A)(vii)	Tax Levies	Yes	No
8	§72(t)(2)(B)	Medical Expenses	Yes	No
9	§72(t)(2)(C)	QDROs	Yes	No
10	§72(t)(2)(D)	Health Insurance Premiums	No	Yes
11	§72(t)(2)(E)	Higher Education	No	Yes
12	§72(t)(2)(F)	1 st Home Purchase	No	Yes

CHAPTER 2 --- COMMON SEPP CONCEPTS

Before we delve into the intricacies of individual SEPP programs, we should spend some time on some basics and concepts common to all SEPP programs. Central to all deferred accounts is the concept of timing. In exchange for the tax deferral granted in earlier years, each taxpayer implicitly agreed to live by Congress's implied definitions of the word retirement. It does not matter if we like or dislike the Congressional definition or are financially able to retire early; we all signed on the first day we opened an IRA or made a contribution to a §401(k) plan.

UNEARNED ORDINARY INCOME

Congress has effectively legislated that withdrawals from deferred accounts are the logical equivalent of retirement and that retirement is essentially a time period or periods during which a taxpayer's unearned⁵⁵ income replaces earned income. Earned income is easy to understand; it is those monies received, typically from an employer, for your personal services, e.g. wages, salary, bonuses and the like. Further, each taxpayer is taxed on earned income when it is earned except for contributions to deferred asset accounts, IRAs, §401(k) contributions and the like. By law, all of the contributions you make, contributions your employer may make on your behalf, as well as any and all earnings and asset appreciation that occur, are all reclassified as unearned income. As a result, some years later, the contents of your deferred accounts are as yet untaxed. Neither the manner, nor the original source of the contributions nor the manner in which asset appreciation occurred is of significance⁵⁶. As a result, all subsequent distributions are taxed as ordinary income using the then present graduated tax rates. As an aside this represents some planning opportunities:

- Generally, if given the option, one would hold assets for long term capital appreciation in a regular after-tax account so that sales of securities will be afforded long term capital gains treatment at lower rates. Additionally, qualifying dividend (but not interest) producing securities are also candidates as dividends are now afforded a maximum tax rate of 15%.
- Conversely, interest income and non-qualified dividend income producing assets are more logical candidates to held in a deferred account as receipt of the income will ultimately be taxed identically, just at a different time.
- Tax free income producing assets such as tax-exempt bonds should never be held in a deferred account. Similarly, "mixed class" assets such as real estate investments, master limited partnership ("MLPs") are generally not well suited for deferred accounts; not because they are poor investments, but, rather they will often lose an important tax feature inside of a deferred account that was potentially one of its attractions in the first place.

⁵⁵ We all know that you really did earn the contents of your deferred account. The distinction being made here is one of semantics and attempting to cause a division between earned income and other types of income. More specifically, all earned income is FICA/Medicare taxed and income taxed when declared. Conversely, unearned income is income taxed when declared but is not FICA/Medicare taxed.

⁵⁶ As always there are exceptions to this rule. See Chapter 3 discussions regarding Roth IRAs and "Net Unrealized Appreciation".

AGE WINDOWS

In concert with indirectly defining the word “retirement”, Congress has created three time windows:

- Before age 59 ½.
- Between ages 59 ½ and 70 ½.
- After age 70 ½.

Before age 59 ½ is called “early retirement”. During this period, Congress had made it intentionally difficult to make deferred account withdrawals. It matters not that you were professionally successful and started a personal savings plan early in life. Congress has deemed that individuals leaving the earned income workforce and substituting unearned income before the age of 59 ½ are early retirees. Further, by implication, Congress is interested in discouraging this activity. Therefore, it imposes extra taxes (namely the 10% surtax) on those individuals who make these early withdrawals. Fortunately, Congress did give us some narrow windows of opportunity.

Stage two, from ages 59 ½ to 70 ½ is typically called “normal retirement”. During this time period, taxpayers typically have unlimited freedom to make or not make deferred account distributions. The only requirement is that the taxpayer must pay ordinary federal income taxes. As a further aside, this does present some tax planning opportunities:

- Consider changing your state of residency during periods of potentially high deferred account distributions to a state that either exempts or materially credits retirement distributions. Similarly, there is nothing wrong with a state that has no income tax.
- Consider maximizing stage two period distributions to maximize lower tax bracket usage. As an example, if you are in low end of the 25% federal tax bracket, consider withdrawing additional amounts, so to speak, early and reinvesting the net after-tax proceeds in capital gains creating assets or tax free assets. This is particularly true for taxpayers with large IRA accounts that can be projected to materially grow such that commencing at age 70 ½ the minimum required distributions will catapult one into a higher tax bracket.

Stage three really doesn't have a name, but it commences at age 70 ½. At this point, Congress reverses itself and instead of making distributions difficult, as they are in stage one, Congress now mandates minimum withdrawals⁵⁷ even though you may not want to make them. These are called the minimum required distributions or MRD's which start at approximately 3.6% of your aggregated IRA

⁵⁷ IRC §401(a)(9)(c) & §4974(a).

balances commencing at age 70 ½ and rising 2/10ths per year to 5.6% at age 80 and 8.8% at age 90. Not meeting the MRD's is extremely painful to the tune of a 50% excess accumulations tax to the extent that your distributions fall short of the MRD in any one year.

THE ACCOUNT CONCEPT

A taxpayer (or taxpayer & spouse) is almost always treated as a single taxable entity. Thus, if we think about IRS Form 1040, it starts to make some sense. Through the use of a blizzard of subsidiary forms (one for interest & dividends, another for capital gains and yet another for farm income) all taxpayer income eventually flows upwards and will land somewhere on Form 1040. It is on this form that the whole taxpayer's income situation is revealed and the income tax is imposed.

IRC §72(t) and SEPPs work in the exact opposite manner. Instead of treating the taxpayers as a single taxable entity, the taxpayer's accounts are fragmented into pieces. As we will learn later, this is actually an advantage as SEPPs are structured, evaluated and used on an account-by-account basis⁵⁸. For example, it is quite conceivable that a taxpayer might have three, or six or even nine separate deferred accounts. To commence a SEPP program, this taxpayer faces two fundamental choices:

- Select one and only one of the nine deferred accounts⁵⁹ and commence a SEPP program on only that account. The other eight accounts are held on the sidelines for future use at future dates.
- Select more than one of the accounts up to and including all nine of the accounts by creating a "SEPP universe⁶⁰". Let's assume accounts 1,2 & 3 are selected holding accounts 4 through 9 on the sidelines. The SEPP program is computed using the sum of the balances of accounts 1,2 & 3 resulting in a determined annual distribution amount. Going forward,

⁵⁸ PLR 89-46045 is the 1st of multiple PLRs that dealt with the issue of taxpayers with multiple IRA accounts. In specific, the IRS ruled: "during the period of distributions...you need not take distributions from your other IRAs or consider the account balances of those IRAs when calculating the amounts of the annual distribution necessary under §72(t)(2)(A)(iv)." This same concept is addressed, albeit more clearly and thoroughly, in PLR 90-50030 in which the IRS ruled: "IRC §72(t)(2)(A)(iv) does not require that plans be aggregated to calculate a series of substantially equal periodic payments. Accordingly...we conclude that the monthly distributions from the rollover IRA...are not subject to the 10% additional tax...regardless of whether similar distributions are made from other regular IRAs maintained by you...and that the account balances of the other IRAs need not be considered when calculating the amounts of the annual distributions necessary...". This same issue of multiple IRA accounts and selecting one or more for a SEPP program and exclusion of other IRAs is addressed several more times in PLRs. Each time the IRS's response has been consistent with the above.

⁵⁹ See PLR 2003-09028 wherein the IRS said: "§72 and the applicable regulations do not require the aggregation of all IRAs owned by the same taxpayer for purposes of [applying] §72(t)(2)(A)(iv)."

⁶⁰ See PLR 91-23062. In this case, a taxpayer logically aggregated the balances of two of his IRAs for distribution amount computation.

that annual distribution amount can be made in any proportion from any of the three accounts defined in the universe. Once the universe is defined and the SEPP withdrawal is made, the contents or membership of the universe is fixed and can not be changed. For example, accounts 4 & 5 can not be added to the universe at a later date; further, the annual distribution amount must be withdrawn from IRAs 1,2 or 3 only.

This concept of fracturing the taxpayer's deferred accounts only applies before age 59 ½ and will work to our advantage in designing multiple SEPP programs that can run concurrently or launch at different times. Between age 59 ½ and 70 ½ this concept is irrelevant as withdrawals are unstructured and penalty free. When the taxpayer reached age 70 ½, Congress again reverses course and requires that all deferred accounts be aggregated together, not physically, but for the purposes of measurement and computation of the annual required minimum distribution amount⁶¹.

To conclude, the seminal ruling on this issue is PLR 95-25062 in which a taxpayer received a qualifying lump sum distribution from an employer plan and placed 100% of that distribution into an IRA. Then, the taxpayer transferred dollars from IRA #1 into newly created IRA #2 and IRA #3. Lastly, the taxpayer decided to commence a SEPP plan based upon the sum of IRA #2 and IRA #3 leaving IRA #1 untouched (and therefore available for other future plans and purposes).

The IRS ruled favorably saying: “We further conclude that the periodic payments derived using the proposed methodology (the annuity method in this case) may be computed with respect to the aggregated account balances of IRA #2 and IRA #3 only, without taking any other IRAs owned by the taxpayer into account.”

INDIVIDUAL OWNERSHIP

Deferred accounts are always owned individually⁶². There is no such thing as a jointly owned IRA. Thus, in addition to the account concept discussed above, married taxpayers are split apart when considering SEPPs. This is actually good news. As a result, one spouse can commence SEPPs while the other spouse does not. Further, the application of SEPP rules, such as duration and the age 59 ½ rule are applied individually to each SEPP program launched by each spouse.

For a working couple now contemplating early retirement, the situation starts to look like a matrix with the horizontal axis being “his and hers” and the vertical axis becoming the different deferred accounts owned by each individual. The lowest common denominator is any intersection point in the matrix as represented by a person/account permutation. This is the beginning level, the “atom” if you will, of SEPPs. SEPPs can aggregate vertically but may never aggregate horizontally. As an example, John & Cathy have both had working careers and have each accumulated a variety of deferred account types

⁶¹ IRC §408(d)(2)(A) & (B).

⁶² It is easy to forget that the “I” in IRA stands for “individual”.

through a succession of employers:

Deferred Account Type	John		Cathy	
	Amount	Acct.	Amount	Acct.
Current 401(k) Plan	\$400,000	1	\$65,000	6
Lump sum distribution from an old "DB" plan	\$75,000	2	\$25,000	7
Self funded IRA	\$300,000	3	\$150,000	8
SEP IRA	\$100,000	4	\$200,000	9
Rollover IRA from prior employer's 401(k) plan	\$200,000	5	\$85,000	10
Totals	\$1,075,000		\$525,000	

Between the two of them, 10 different accounts exist totaling \$1.6 million. Valid combinations to create a SEPP universe would be any or all of John's accounts (1, 2, 3, 4 and 5) or any and all of Cathy's accounts (6, 7, 8, 9 and 10). Combining any of John's accounts with any of Cathy's accounts would be invalid.

RELATIONSHIP TO EARNED INCOME

During a working career, most taxpayers more than likely received earned income in the form of a paycheck from an employer. Conversely, SEPPs are classified as unearned income⁶³. These two types, although taxed similarly, are unrelated. Neither type of income prohibits the creation or receipt of the other. Thus, it is perfectly okay to be receiving SEPPs from your IRA and at the same time be gainfully employed (or self-employed) as you so chose. This also presents some tax and financial planning opportunities with respect to commencing SEPPs and then launching into a new career or business.

⁶³

As mentioned earlier, there is no prejudice intended in the use of the terms "earned" and "unearned". It just a matter of labeling to keep clear how present and future period taxation will take place. Further, it is a common event for a taxpayer currently making SEPPs to also want to make an IRA contribution. This is not permitted, at least not from SEPP distributions. Instead, the taxpayer must have earned income from some other source and then make an IRA contribution based on that earned income.

REVERSIBILITY AND ERRORS

In many cases, the Internal Revenue Code or the regulations provide methods for a taxpayer to reverse course, sometimes years after an initial tax decision has been made. This is NOT one of those cases. Within our general context of discussion, SEPPs are never reversible. However, if we broaden our scope momentarily, there are two circumstances where SEPPs can be reversed. They are:

- Annual rollover --- A taxpayer can always make a withdrawal from a deferred account and replace those withdrawn funds within 60 calendar days. This is then classified as a rollover⁶⁴ & each taxpayer is allowed one rollover per year per account. It is not our intent to make use of this feature; however, it can be used to provide a limited time window in which correct mistakes⁶⁵.
- Surtax --- A taxpayer can always intentionally stop the SEPP withdrawals at any time and suffer the wrath of IRC §72(t)(4); namely the application of the 10% surtax plus statutory interest. Again, it is not our intention to take advantage of this feature; further, it is pretty hard to conceive of this strategy as any kind of advantage at all⁶⁶.

The situations discussed above are really far reaching exceptions. The central point here is that each taxpayer should view the commitment to a SEPP program as irrevocable. Further, the IRC does not differentiate between a change in taxpayer circumstances⁶⁷ and errors. Errors can be mistakes in theory as well as practice. A taxpayer may believe he or she has properly interpreted how to apply one of the approved methods. The taxpayer may be wrong resulting in a “theory error”. Or, a taxpayer may have the theory down pat and properly interpreted but may make a date or math computational error. This, then

⁶⁴ IRC §408(d)(3)(A)(i).

⁶⁵ There is also a strategy wherein a taxpayer creates seven different IRA accounts of approximately equal size and makes overlapping withdrawals starting on the 1st day, 54th day, 108th day, etc. making a withdrawal on day 1 of \$10,000 from IRA A, making a 2nd withdrawal from IRA B of \$10,000 on the 54th day placing that money back in IRA A to satisfy the 60 day rollover rule. In this manner, a taxpayer can essentially lend oneself approximately 1/7th of the sum total of the IRAs value. This strategy is permissible and does, in fact, work. However, this author thinks that there is too much work involved compared to the benefit received.

⁶⁶ One potential situation exists where a taxpayer has dutifully planned out the next 5 to 10 years and has designed a SEPP program to meet those needs; launching same in the very recent past. Then, a large & totally unexpected windfall occurs; e.g. some one has to win the Powerball lottery. In this type of situation, it may be beneficial to terminate the SEPP & pay the penalty; however, this predominately becomes a tax bracket analysis problem.

⁶⁷ The exception here are divorce situations where the corpus of the IRA is being split pursuant to a QDRO (“qualified domestic relations order”). This will be covered in more detail in Chapter 6.

becomes a “practice error”. In either event, the IRC treats changes in taxpayer circumstance, theory errors and practice errors equally. All three events are considered a “modification” therefore resulting in the application of the 10% surtax plus interest. The finality with which the surtax is imposed suggests some strategies for taxpayers:

- Plan, plan and then re-plan your cash flows as well as SEPP program design. When you think your done, re-plan it again.
- Document your SEPP program in a letter or contract to yourself spelling out all of the details right down to the plan assumptions, account numbers & balances, etc.
- Taxpayers who are the least bit hesitant or uncertain should obtain a professional review of the intended program including consideration of receiving an opinion letter from a licensed professional CPA or tax attorney.

Sometimes a taxpayer will do everything right and still an error occurs causing what would appear to be a “modification” thus incurring the penalties and interest. Does this mean that those interest and penalty amounts are automatically applied? Not necessarily. In 2002, Congress amended IRC §408 to include:

(I) Waiver of 60-day requirement

The Secretary may waive the 60-day requirement under subparagraphs (A) and (D) where the failure to waive such requirement would be against equity or good conscience, including casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement.

Accordingly, The IRS issued Revenue Procedure 2003-16 in the Spring of 2003. This procedure describes how the IRS will exercise its newly granted authority to grant a waiver to the taxpayer for an exception to the 60 day rollover rule⁶⁸:

⁶⁸

IRC §408(d)(3)(A)(i).

The Service will issue a ruling waiving the 60-day rollover requirement in cases where failure to waive such requirement would be against equity or good conscience, including casualty, disaster or other events beyond the reasonable control of the taxpayer. In determining whether to grant a waiver, the Service will consider all relevant facts and circumstances, including: (1) errors committed by a financial institution...(2) inability to complete a rollover due to death, disability, hospitalization, incarceration, restrictions imposed by a foreign country or postal error; (3) the use of the amount distributed (for example, in the case of payment by check, whether the check was cashed); and (4) the time elapsed since the distribution occurred.

Revenue Procedure 2003-16, SECTION 3.02

Thus far the Service has issued a variety of waivers which to-date have all focused on natural catastrophes and hospitalization / incapacitation of the taxpayer circumstances. In addition, the Revenue Procedure grants automatic approval for simple administrative errors committed by financial institutions. As a result, we now have a mechanism in place to stretch the 60 day rollover window. As always, there are rules:

- (1) A waiver is (potentially) obtained by the filing of a waiver request to the Internal Revenue Service. This waiver request is not unlike a private letter ruling request; however, it is substantially shorter & simpler. In addition, for 2004, the IRS requires a check for \$95⁶⁹ in order to review the request.
- (2) The granting of the waiver is a “facts & circumstances” test which implies that one must fully describe all of the relevant facts and circumstances within the waiver request. We already know that the obvious situations will be approved; e.g. natural catastrophes, hospitalizations, etc. But, what about some not so obvious situations?

As an example, John designed a SEPP plan to distribute \$75,000 per year and was doing so by making individual distribution requests to his trustee throughout the year timed to meet his specific financial needs. He inadvertently made an extra distribution in November; thus over-distributing and does not discover the error until the following March when he commences working on his tax return. Is John’s situation covered here? The short answer is we don’t know. We would like to think so but we can not be sure as no waiver requests have been published that appear on point.

In summary, there are limited corrective mechanisms available for SEPP program errors & taxpayers should know that they exist. However, our beginning position should still apply; always think of a SEPP program as a one-way street — irrevocable. Better to have not made an error that to

⁶⁹ Revenue Procedure 2004-8, Section 6.01(3).

contemplate whether or not the error made is correctable.

BASIS IN ACCOUNT

So far, our entire conversation about SEPPs has assumed that the entire deferred account balance is taxable as unearned ordinary income. This not always the case. The most common exception is the individual who has made a number of non-deductible IRA contributions to the IRA in prior years. In this situation, the IRA really has a mixture of funds, sometimes called “money types”. They are:

- Lifetime-to-date non-deductible IRA contributions.
- Lifetime-to-date deductible IRA contributions plus any and all earnings & asset appreciation which has occurred.

For example, assume a taxpayer wishes to commence a SEPP program on an IRA with a current total value of \$100,000, of which \$20,000 was originally from after-tax contributions. The remaining \$80,000 is therefore from some mixture of deductible contributions as well as asset appreciation over the years. Further, let’s assume that the 1st year annual distribution amount is \$5,000. Only \$4,000 is includible in the gross income of the taxpayer; \$1,000 is excluded as a ratable return of basis in the account.

The return of basis issue can get considerably more complex in subsequent years when accounting for additional account appreciation or when a taxpayer selects a multiple-account SEPP universe. Since IRS Publication 590 and Form 8606 do an excellent job of covering these situations, we will not repeat them here. However, the basic concept continues into future years --- that being a mathematical computation to arrive at a percentage or dollar amount representing a prorated return of basis each year.

However, there is one unusual situation worth review. IRC §408(d)(2)(A) says: “all individual retirement plans shall be treated as one contract.” This would lead one to the conclusion that a taxpayer should generally think about all of his or her IRAs as one big aggregated IRA. True, but, as we have already seen, the IRS has taken a very narrow interpretation of this language for the purposes of designing a SEPP plan; e.g. a taxpayer may build and then “cherry pick” which IRA account(s) to use. Now, let’s examine the distribution that might occur. Assume John has two IRAs with \$1,000,000 and \$500,000 respectively. Further, John, through lifetime-to-date non-deductible contributions has basis of \$30,000 in IRA #2. He launches a SEPP plan using IRA #1 only distributing \$60,000 per year. How much of the \$60,000 is taxable; e.g. includible in income? \$58,800! IRC §408(d)(2)(A), for distribution purposes, requires the aggregation of both IRAs (even though no distribution was made from IRA #2). Thus, the taxable income computation becomes: $(\$60,000 * (1 - (\$30,000 / (\$1,000,000 + \$500,000))))$. Said another way, a taxpayer may cherry pick the IRAs to be used in the design of a SEPP plan; but may

not cherry pick for the purposes of computing the taxable income result⁷⁰.

PENALTY COMPUTATIONS

Almost all of this text is explicitly devoted to avoiding the surtax. Nonetheless, a common characteristic of all SEPP programs is the danger that, for whatever reason, the IRS will examine and disqualify your SEPP program therefore applying the surtax & interest.

*“...the taxpayer’s tax for the 1st taxable year in which **such modification** [emphasis added] occurs shall be increased by an amount, determined under regulations, equal to the tax which (but for paragraph (2)(A)(iv)) would have been imposed, plus interest for the deferral period.”*

IRC §72(t)(4)

What does the above mean? This is essentially a “look back” tax that says that if a “modification” occurs, then the additional tax is going to be immediately due in and for the same tax year in which the modification occurred. Further, this additional tax is computed by going back to the 1st year in which the SEPP program commenced and for that year and every intervening year recomputing the tax due for each year by applying the 10% surtax. Thus, we end up with an additional tax due for each year of the SEPP program since commencement. Secondly, for each year that is not the current year, statutory interest is charged as a further penalty for not having paid the additional tax when originally due.

For example, assume a taxpayer, aged 52, commenced SEPPs of \$10,000 per year and continued the program for five years, the year in which he attains age 57. In year six, when the taxpayer turns 58, he withdraws \$20,000. This would clearly be classified as a modification that violates the greater of 5 years or age 59 ½ rule. Given that he has already completed six years, he would an approximate penalty of \$8,199⁷¹. Referring to the table below, we can see that the total penalty increases at a geometric pace the further one progresses into a SEPP program.

⁷⁰ Taxpayers in this situation should pay close attention to Form 8606 which will be required.

⁷¹ See the above penalty table. Because the modification occurred during year six; the table estimates the total penalty at \$7,199. To this we need to add an additional \$1,000 of penalty for the extra \$10,000 withdrawn in year six for a total of \$8,199. The table assumes a statutory interest rate equal to the long-term applicable federal rate which has average 7.25 % over the last ten years.

Approximate Computation Of §72(t)(4) Surtax and Interest

Year	Beginning Balance	Penalty Assessed	Statutory Interest Charged	Ending Balance Due
1	\$0	\$1,000	\$0	\$1,000
2	\$1,000	\$1,000	\$73	\$2,073
3	\$2,073	\$1,000	\$150	\$3,223
4	\$3,223	\$1,000	\$234	\$4,456
5	\$4,456	\$1,000	\$323	\$5,779
6	\$5,779	\$1,000	\$419	\$7,199
7	\$7,199	\$1,000	\$522	\$8,720
8	\$8,720	\$1,000	\$632	\$10,353
9	\$10,353	\$1,000	\$751	\$12,103
10	\$12,103	\$1,000	\$877	\$13,981

Notice that the interest charges in years one through three are pretty meaningless such that a modification in year three would cost the taxpayer approximately 32% of the annual distribution amount. However, by year seven, the penalty is not 70% of the annual SEPP amount, but 87%. This percentage leaps to 140% by the end of year ten. Please note that the 10% surtax plus interest is not only due on the modified withdrawal; instead a modification has the effect of disallowing the entire distribution stream from inception; thus the 10% surtax is imposed on all amounts withdrawn. As a result, if a taxpayer is ever tempted, typically by a very material change in personal circumstance or finances, to intentionally modify their SEPPs, they should clearly do so early in the SEPP program as opposed to later.

In addition to the 10% surtax plus interest; one's "tax life" can potentially get worse. The IRS can also assess, to the extent applicable, an accuracy related penalty⁷² equal to 20% of the additional tax owed. This additional penalty is usually imposed for either of two reasons: (1) negligence or disregard of the rules and regulations; or (2) substantial understatement of income tax due; defined as the greater of 10% of the tax required or \$5,000.00. As a result, if a taxpayer modifies their SEPP plan, not only do they owe the surtax plus interest, they owe it relatively quickly if for no other reason than to avoid an additional 20% penalty.

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IRC §6662 & T.C. Memo 2004-27 Norma A Cohen v. Commissioner.

CHAPTER 3 - ROTH IRAs AND NET UNREALIZED APPRECIATION

What do ROTH IRAs and Net Unrealized Appreciation have to do with SEPPs? Nothing and everything. “Nothing” in the sense that these two topics are mutually exclusive of each other as well as in relation to SEPPs. Further, implementation of these two topics is limited to a select sub-set of taxpayers who meet certain conditions. “Everything” in the context that these two topics are very powerful and should always be addressed first and potentially implemented first to the extent that it is “tax wise” to do so. Then SEPPs become a remainderman process after using these topics.

Thus far, our entire focus has been the elimination of the 10% surtax imposed by IRC §72(t)(4) by analyzing and then potentially implementing one or more of the available exceptions. In each of those cases, the 10% surtax is avoided; however, more often than not, regular federal income tax is still due. Further, in this context, virtually all deferred account balances are in-fact “tax deferred” only; thus federal tax is always due, it is simply a matter of when. However, there are two exceptions where some or all federal tax can be completely avoided; essentially specific mechanisms to create whole or partial conversion of deferred-like accounts from tax deferred to tax free.

ROTH DEFINITION

In the Taxpayer Relief⁷³ Act of 1997, Senator William Roth championed a new type of IRA, accordingly called the Roth IRA⁷⁴. For brevity purposes, we are going to shorten this to a “Roth”. The rules for Roths are completely different from all other types of IRAs and have the following characteristics:

- Unlike regular IRAs, no deduction is ever afforded for making a contribution. Further, the ability to contribute to a Roth is generally limited to \$3,000 per year for 2003 and 2004⁷⁵ for those taxpayers with less than \$110,000 or \$160,000 of adjusted gross income for single and married filing jointly taxpayers, respectively.
- Taxpayers with not more than \$100,000⁷⁶ of adjusted gross income can also elect to convert

⁷³ In the author’s opinion, this is an oxymoron. There is no “relief” here, just a partial abatement or slowing of increased federal taxation over the years.

⁷⁴ See IRC §408A and related regulations.

⁷⁵ Limits for 2005 - 2007 are \$4,000, 2008 is \$5,000 and is further indexed upward based on CPI commencing in 2009.

⁷⁶ A taxpayer may have AGI of not more than \$100,000 and may wish to convert IRAs of such a size that their resultant AGI exceeds the \$100,000 limit. This is okay in that the AGI limit test; imposed by IRC §408A(c)(3)(B) ignores the amount of the conversion in the computing the taxpayer’s AGI.

some or all of their regular IRAs into Roths; however, this does create a taxable event on which regular federal income tax (but no penalty) is due⁷⁷.

- Distributions from Roths are categorized as either qualified or unqualified. If the distribution is qualified; then it is a tax free distribution, irrespective of the composition or source of the distribution dollars. If a distribution is unqualified, it is potentially taxable depending a new set of special ordering rules discussed following.

QUALIFIED & UNQUALIFIED WITHDRAWALS

Since there are many fine texts written about Roth contributions, conversions and recharacterizations, we will skip past all of these issues and instead focus on the distribution side of the equation. Our objectives, first and foremost, are to completely avoid taxation and, second, if forced into a taxable event, to avoid the 10% surtax imposed by IRC §72(t). To do this we need to first understand the differences between qualified and unqualified distributions. A qualified distribution is one that is BOTH:

- Made after a 5-taxable-year period, and
- Made on or after the date on which the taxpayer attains the age of 59½, or made to a beneficiary or the estate of the owner on or after the date of the owner's death, or attributable to the owner's being disabled, or for a first time home purchase.

An unqualified distribution is any distribution that does not meet the two rules above.

APPLICATION OF THE “5-TAXABLE-YEAR” RULE

Based on the permissible types of transactions for a Roth, we potentially create three classes of assets or dollars within a Roth account: annual contributions, conversions (from regular IRAs), and all earnings. Each of these asset classes receives different tax treatment upon distribution depending on the character of the distribution; e.g. qualified or unqualified.

Part two of the test above maps identically to exceptions 1, 2, 3 and 12 discussed in Chapter 1; but what is a “5-taxable-year period”? Earlier, we discussed the concepts of date specificity and highest attained age. A 5-taxable-year period unfortunately has a new and different set of rules. A 5-taxable-year period commences with the first contribution to a Roth account and is effectively back-dated to January 1st of the allocable tax year of the contribution and ends on December 31st of the 5th year. Actually, 5-taxable-year period could have been better phrased as “five complete taxable years excluding the present taxable

⁷⁷

On its face, a conversion from a regular IRA to a Roth is a withdrawal from the regular IRA and therefore subject to the 10% surtax under IRC §72(t). However, IRC §408A(d)(3)(A)(ii) gives us a break by saying that “§72(t) shall not apply”.

year”. Some examples are in order:

- January 1, 1998 was the first date ever that one could create a Roth and make a contribution. Let’s assume you created the Roth account in March, 1998 and made a \$1,000 contribution in June, 1998 followed by another \$1,000 contribution in February, 1999, but allocated to your 1998 tax year⁷⁸. In this case, the “5-taxable-year period” commences on January 1, 1998 and concludes on December 31, 2002; five complete tax years later. Further, any subsequent year Roth contributions you might make, say for tax years 1999, 2000 and 2001, will all be afforded the same back-dating for the purpose of measuring the five years. Thus, the first date in history that you can make a qualified withdrawal is January 1, 2003⁷⁹, one day after completion of the 5-taxable-year period.
- Assume the same facts as above, however, you didn’t get the word quickly enough and therefore didn’t open a Roth account until March, 2000. In this case, the 5-taxable-year period commences January 1, 2000 and completes on December 31, 2004. Thus, the first date to make a qualified withdrawal would be January 1, 2005.

Let’s now return to the tests for a qualified withdrawal. All one needs to do is to satisfy the 5-taxable-year rule **AND** be 59 ½ (or older) on the date of withdrawal (or be deceased, disabled or making a first home purchase). When the withdrawal is qualified, the benefits are enormous: **NO FEDERAL INCOME TAX**. No tax now, no tax later, no tax never, of any kind⁸⁰. Thus, every taxpayer’s first objective should be to always attempt to make qualified withdrawals.

CONTRIBUTION & EARNINGS WITHDRAWALS

What if a taxpayer must make a withdrawal but will also fail the qualified test? All is not lost. Back in Chapter 2, we discussed “basis in account” and the concept that withdrawals from regular IRAs could be part taxable and part tax free⁸¹ with the “basis” being withdrawn ratably with the taxable component. Well, here is a second gift thanks again to Senator Roth --- unqualified withdrawals are ordered or sequenced such that 100% of a taxpayer’s contributions are deemed to have been withdrawn first, and only after all contributions dollars have been exhausted are earnings deemed to have been withdrawn. Again, some examples are in order:

⁷⁸ As a general rule, taxpayers have until April 15th of the year following to make an IRA contribution allocable to the prior year. This feature is afforded to Roths as well.

⁷⁹ IRC §408A(d)(2)(B) says in part, “[that the qualified withdrawal status is disallowed]...if such payment or distribution is made within the 5-taxable-year period...”.

⁸⁰ IRC §408A effectively says that a qualified withdrawal from a Roth is “not includible in the gross income of the taxpayer.” Therefore, the withdrawal is tax free and IRC §72(t) does not apply by virtue that §72(t) only applies to “the portion of such amount that is includible in gross income.”

⁸¹ Actually, this would not be tax free, simply that “basis” has been previously taxed, when the contributions were put in the IRA account and are simply not taxed a second time.

- It is August, 2002 and you are 45 years old. You created a Roth in 1998 and you have diligently made a \$2,000 contribution for each tax year from 1998 through 2002; totaling \$10,000 in contributions. Through some astute investing, the total account balance is now \$22,000; thus, \$12,000 is classified as earnings. For whatever reason or emergency, you must make an \$8,000 withdrawal. Although unqualified, the \$8,000 withdrawal is a tax free because it is 100% comprised of contribution dollars on which you have already paid income tax. The \$8,000 is therefore not includible in gross income and §72(t) does not apply.
- Assume the same fact set as above, however, the emergency is of a nature requiring a \$12,000 distribution. In this case, the first \$10,000 (your lifetime-to-date contributions) are deemed to have been distributed first and are distributed tax free. The last \$2,000 is another story. Because the total distribution is classified as unqualified, the \$2,000 becomes includible in gross income and therefore taxable. Not surprisingly, not only is the \$2,000 taxed (at whatever is your then regular income tax bracket), but §72(t) rears its ugly face again. Because the \$2,000 is taxable, §72(t) applies, and (unless one or more of the 12 exceptions apply) the 10% surtax, \$200 in this instance, is enforced.

What can we learn from this? On the contribution side, Roths are a very powerful investment and asset accumulation tool. Done correctly, they are tax free forever. This point is critical in comparison to all of the other deferred asset accounts we discuss. In the later case, withdrawals are always going to be taxed, it is simply a matter of when and how much. Tax free is always better and a Roth is currently the only place to get it. On the withdrawal side, first and foremost, always endeavor to make qualified distributions only. Secondly, if you must make an unqualified distribution, withdraw only amounts up to your lifetime-to-date contributions as these are also tax free. Only in the most catastrophic circumstance should one consider making an unqualified distribution of earnings dollars because they will be both taxed and surtaxed as one or more of the 12 exceptions will most likely not apply.

Further, assume for a moment that a taxpayer has both regular IRAs and Roths and has already withdrawn all of his or her lifetime-to-date contributions from the Roth. However, should an emergency arise, from which account should the taxpayer make further withdrawals? Without question, one should next withdraw from the regular IRA, not the Roth. Since taxes and penalties are going to be the same for withdrawals from either account, the deciding factor is then based on which dollars are more beneficial to protect. Clearly, Roth dollars are more precious in that on some future date they will become tax free whereas the regular IRA dollars will always be taxed at some future date.

CONVERSION DOLLAR WITHDRAWALS

At the outset of this chapter we talked about three types of money in a Roth --- contributions, earnings and conversion dollars. So far we have covered the rules for contributions and earnings which are, although different from regular IRAs, relatively straight-forward. The rules for conversion dollars are again different and unfortunately, more complex. Whereas all contribution dollars are permitted to satisfy the 5-taxable-year rule commencing in the year the Roth was first opened, this luxury is not afforded to conversion dollars. Instead, each conversion receives its own discrete beginning date for 5-taxable-year testing. As an example, assume some similar facts as discussed above: you made

contributions of \$2,000 per year for 1998 through 2004; further, you also converted \$10,000 each year from one of your regular IRAs in 1998 through 2001. Finally, assume that the total Roth balance as of August, 2004 is \$90,000. Now a new set of ordering rules comes into play:

- \$14,000 of Roth contributions (1998 through 2004 inclusive).
- \$10,000 of Roth conversion (performed in 1998).
- \$10,000 of Roth conversion (performed in 1999).
- \$10,000 of Roth conversion (performed in 2000).
- \$10,000 of Roth conversion (performed in 2001).
- \$36,000 of Roth inception-to-date earnings.

In a way, the Roth account starts to look like a layer cake with different taxability rules applying to each layer. Remembering that you are 45, all withdrawals are therefore unqualified. Let's see what happens under different circumstances:

- If you make a withdrawal of \$14,000 or less, it is a tax free distribution comprised entirely of lifetime-to-date contributions only.
- If you make a withdrawal of \$30,000, it will be deemed to be comprised of:
 - ◆ \$14,000 of lifetime-to-date contributions.
 - ◆ \$10,000 of the 1998 conversion layer.
 - ◆ \$6,000 of the 1999 conversion layer.

We are still okay because in tax year 2004 both the 1998 and 1999 conversion layers have each sufficiently aged independently to satisfy the 5-taxable-year rule. The 1998 \$10,000 has been in the account for six full tax years (1998 - 2003) and the 1999 \$10,000 has been in the account for five full tax years (1999 - 2003). Further, because the conversion dollars were taxed when you converted them from a regular IRA to the Roth, they can not be taxed a second time. Thus, all \$30,000 comes out tax free.

- Now, let's look at a \$54,000 withdrawal. The first \$34,000 comes out tax free representing the lifetime-to-date contributions plus the first two conversion layers, both of which have satisfied the 5 year rule. However, the tables turn with respect to the last \$20,000. This last \$20,000 maps to the last two conversion layers from 2000 and 2001. Unfortunately, these last two layers do not satisfy the 5 year rule having only been inside the Roth account for 4 and 3 years respectively. Thus we get some mixed news:
 - The good news is that the \$20,000 was taxed when converted from regular IRA

assets. Therefore, the \$20,000 is NOT taxed a second time.

- The bad news is that \$20,000; when it was originally converted from a regular IRA was exempted from the application of §72(t)⁸². This treatment and language was needed; otherwise virtually all IRA to Roth conversions would be taxed and surtaxed. However, this exemption is conditional. IRC §408A(d)(3)(F)(I)⁸³ says that we need to re-apply §72(t) as if those distributions were taxable income. We know that the \$20,000 of conversions are, unto themselves, not taxable because they have already been taxed when the conversions occurred. This code section is saying that we need to temporarily pretend that they are taxable for §72(t) purposes. As a result, given the unlikelihood that a §72(t) exception will apply to this situation, a 10% surtax of \$2,000 will be assessed.
- Let's take a look at the last and worst case; you withdraw all \$90,000. The first \$34,000 comes out tax free. The next \$20,000 also comes out tax free but is surtaxed for \$2,000. The last \$36,000 comes out and is taxable income (let's assume at the 28% rate) and is further surtaxed at 10%. The total tax bill is \$15,680⁸⁴ of which \$5,600 are §72(t) penalties.

NET UNREALIZED APPRECIATION (NUA)

If the third word were “appreciosis” everyone would be convinced we were discussing a

⁸² IRC §408A(d)(3)(A)(ii) says in part “Rollovers from an IRA other than a Roth IRA... section 72(t) shall not apply...”.

⁸³ On the one hand, these “pretend to look back” rules appear to be convoluted and downright silly. On the other hand, they represent the ultimate in logical thinking. IRC §72(t) was on the books for several decades before the creation of Roth IRAs. Further, the primary purpose of §72(t) is to make it difficult and/or costly to access regular IRA assets before the age of 59½. Assume you are in your 40s or early 50s and wished to make withdrawals from your regular IRAs but did not qualify for any of the exceptions. All else being equal, you could certainly do so but would be subjected to the 10% surtax. However, were IRC §408A(d)(3)(F)(I) to be absent, one could easily convert from a regular IRA to a Roth periodically as needed and then make the withdrawals from the Roth when needed, essentially circumventing §72(t).

⁸⁴ A 17½% tax rate at first blush doesn't seem too bad. However, when one considers that the tax rate could have been zero, then 17½% appears to be a disaster. What if you are 57 and an emergency presents itself requiring the \$90,000. Should you withdraw the money from the Roth? Maybe, as a court of last resort. However, as one approaches age 59½, it can actually be “tax smart” to borrow from other sources in order to preserve the tax free status of the Roth dollars just over the horizon.

terminal illness⁸⁵. Fortunately, it's not. Instead, NUA is a very powerful tax avoidance⁸⁶ tool which is unfortunately limited to a select group of taxpayers. As a general rule, all taxable distributions made from a deferred account⁸⁷ are taxed at the federal level from 15% to 35% as ordinary income for most taxpayers. Electing NUA treatment on employer securities held in an employer sponsored retirement plan permits conversion of the gain in those employer securities from ordinary income to long term capital gains income taxed currently at a maximum rate of 15%. Further, recognition of the gain is postponed until the securities are sold. Thus, depending on a taxpayer's marginal income tax bracket, a savings of 10% to 20% can be achieved.

The ability to use NUA is governed by IRC §402(e)(4) and related IRS regulations and only applies to employer securities currently held in a qualified §401(a) trust⁸⁸. These securities may be securities of the corporation itself, its parent or subsidiary. Further, these securities may be any type of security; e.g. common stock (of any class), options to purchase common stock, preferred stock, or indebtedness (regular or convertible). However, as will be discussed following, typically the only time electing NUA treatment is of any material benefit is when either common stock, an option, or a convertible bond, any of which has materially appreciated, is held in the participant's account.

As is usual, there are a variety of rules or tests that must be satisfied for a taxpayer to elect NUA treatment. They are:

- (1) The securities must be held in a qualified IRC §401(a)⁸⁹ trust. The securities may be in the employee's "before-tax" account, employer matching account or the employee's "after-tax" account.
- (2) The employee must be "separated" from his or her employer. Neither the manner of this separation, nor the passage of time from date of separation to date of election is relevant.
- (3) The employee must elect; usually with a form submitted to the plan administrator or plan

⁸⁵ Actually, it would be a terminal financial illness if one did have net unrealized appreciation/depreciation in: Enron, Worldcom, Global Crossing, etc.

⁸⁶ Please remember that "tax avoidance" is always very legal and sometimes fun; conversely, "tax evasion" is always illegal. It too may be fun at least until one is caught.

⁸⁷ This would include all §401(a), §401(k), §403(b) plans as well as IRAs qualified under §408(a) and §408A.

⁸⁸ As a result, a common trap which taxpayers may unknowingly fall into is to transfer 100% of their plan assets to a rollover IRA closely following their separation of service. Once done, this step is irrevocable and eliminates or nullifies the taxpayer's ability to elect NUA treatment on the shares transferred as an IRA account is not considered to be a §401(a) qualified trust.

⁸⁹ Typically a §401(a) defined contribution / profit sharing plan of some kind or a §401(k) plan.

trustees, a “qualifying lump sum distribution”, (“QLSD”)⁹⁰. In order for a distribution to be a QLSD, two additional rules must be satisfied:

- (A) The payment(s) must distribute 100% of the participant’s claim in all §401(a) qualified trusts maintained by the employer⁹¹. As an example, an employee may be participant in multiple plans due to his or her long tenure with the employer. 100% of the assets in all plans⁹² must be distributed in order to qualify for NUA treatment.
- (B) The payment(s) from the plan(s) must be completed “within 1 taxable year⁹³”. This is NOT a 365 day test. Instead, it means that all payments required from all the plans involved, in order to distribute 100% of the participant’s benefit, must be made to the participant within the same and single tax year of the participant⁹⁴. As a result, it is typically unwise to commence QLSD processing much past mid-4th quarter as the danger can become too high that some payment might inadvertently fall in to January of the following year, thus negating the taxpayer’s ability to elect NUA treatment.

- (4) As part of the QLSD, the shares of employer securities, on which the taxpayer is going to

⁹⁰ IRC §402(d)(4)(A).

⁹¹ IRC §402(d)(4)(C)(I).

⁹² This can sometimes create a problem. As an example, a employee maybe a participant in two employer sponsored plans: one, a traditional §401(a) defined benefit plan of the type which promises to pay a specified amount per month for the life of the employee commencing at age 65; two, a §401(k) plan which houses some employer common stock in the employee’s before tax account. In this situation, the interpretation of a QLSD means that the employee’s interest or claim in BOTH plans must be distributed. Distributing the employee balances in his or her §401(k) plan will be easy and usually fairly rapid. Distributing the employee’s claim in the §401(a) plan may pose some difficulty. If the employer is unwilling to distribute the employee’s claim in the §401(a) plan, then electing NUA treatment of employer securities is simply unavailable to the separated employee. However, most large employers are aware of this situation and are often willing to compute the net present value of the future pension and deposit those monies into the employee’s §401(k) account and/or purchase an arms-length annuity for the benefit of the employee.

⁹³ IRS Reg. §1.402(a)-1(a)(6). Similarly, in PLR 2004-34022, the IRS ruled against a taxpayer who inadvertently performed a QLSD with financial transactions spanning a calendar year-end.

⁹⁴ Actually, there is a tax debate as to what really happens when distribution payments span a year-end. Some say only the distribution amounts in the second year are disqualified from NUA treatment; others say all distributions are disqualified from NUA treatment. To further complicate matters, the IRS has ruled on both sides of this issue in some very complex factual situations. However, this is not a place a taxpayer wants to find himself in & is much better served by playing it safe and getting all the required transactions completed in one tax year.

elect NUA treatment, must be distributed to the taxpayer causing a taxable event to be recognized in the year of distribution. Said another way, there is no way to distribute the securities in order to elect NUA treatment and at the same time, distribute in such a manner as to additionally shelter the shares distributed.

If the employee satisfies ALL of the above rules or tests; he or she has the right to elect⁹⁵ (but is not required to elect) NUA treatment of the employer securities distributed. To describe how NUA tax treatment works, we will build a hypothetical case study with the following fact set:

- (1) John is 56 years old and has recently separated from his employer, Proctor & Gamble.
- (2) John is a member of two different plans at P&G; their “pension” plan and their “profit sharing plan”. Further, based on John’s recent salary, age & tenure, P&G has offered to place \$400,000 into his profit sharing plan as a replacement for paying John \$1,000 per month for life at age 60.
- (3) As a result of (2) above, John has four different sub-accounts in his profit sharing plan:
 - (A) His before-tax §401(k) contributions & earnings totaling \$300,000. The \$300,000 is invested in a variety of publicly traded mutual funds.
 - (B) His employer-match account which currently contains 3000 shares of P&G common stock. Further, the trustee’s basis⁹⁶ in these shares is an average of \$10 per share. P&G stock recently traded at \$100 per share on the NYSE.
 - (C) His rollover account which now contains \$400,000 as the net present value “cash out” from his defined benefit plan all of which is invested in cash.
 - (D) His after-tax account which contains 1000 shares of P&G stock. John’s lifetime-to-date after tax contributions total \$20,000 and the trustee’s basis in the shares purchased average \$20 per share.

Thus, John’s total profit sharing plan account value is \$1,100,000.

- (4) John elects to do a complete QLSD of all account balances & further wishes to elect NUA

⁹⁵ The taxpayer election is made to the trustee of the plan, usually embedded in a variety of forms designed for that purpose. There is no separate election made to announce or inform the IRS; rather, the IRS learns indirectly through the trustee’s issuance of 1099R forms to the employee.

⁹⁶ In plans where the plan sponsor, P&G in this example, contributes employer stock in lieu of cash, the plan trustee is required by statute to track, in perpetuity, the amounts received from the sponsor as if the plan had paid cash for those shares. As a result, this “basis per share” for all shares owned by John is always a known number and is usually displayed on participant account statements or is readily obtainable from the trustee or plan administrator.

treatment of all⁹⁷ P&G shares housed in both (3)(B) and (3)(D) above.

- (5) John is in the 25% marginal tax bracket for the foreseeable future.

Based upon the above example, John would most likely visit with a P&G employee benefits consultant and complete several withdrawal forms which would document the following transactions & effects:

- (1) The \$300,000 in (3)(A) above and the \$400,000 in (3)(C) above would be liquidated into cash and the trustee of the plan would perform a direct trustee-to-trustee transfer of the \$700,000 from the trust directly to the rollover IRA in John's name at the financial institution of his choosing. The tax effect of this transaction is zero⁹⁸.
- (2) The trust would issue 4000 shares of P&G stock directly to John, or, most likely, John would instruct the trustee to register & issue the shares directly to John's regular brokerage account, again at the financial institution of his choosing. This is a taxable transaction⁹⁹ in the amount of \$30,000 representing the trustee's basis in the 3000 shares housed in (3)(B) above. The 1000 shares distributed from (3)(D) above is a non-taxable transaction treated as a return of basis representing John's lifetime-to-date after-tax contributions. Let's assume that all 4000 shares were distributed on 2/2/04 at a closing price of exactly \$100 per share. Therefore, at the end of this transaction, John has:
 - (A) 3000 shares of P&G with a market value of \$300,000 and a basis of \$30,000.
 - (B) 1000 shares of P&G with a market value of \$100,000 and a basis of \$20,000.

Subsequent to the distribution of assets, John really only has four paths he can choose: do nothing more & continue to hold all 4000 shares; sell some or all the shares immediately; sell some or all the shares later but before 2/3/05; sell some or all the shares on or after 2/3/05. Each of these paths results in different tax treatment.

Path #1 results in John recognizing \$30,000 of income in 2004 representing the trustee's

⁹⁷ John does not have to elect NUA treatment on all of the shares although maximum tax benefit is usually achieved by doing so. John could elect NUA treatment on a portion of the shares while effectively sending the "unelected" shares to his rollover IRA.

⁹⁸ Even though the tax effect of this distribution is zero, the trustee is still obligated to issue a 1099R to the participant; in this case indicating a gross distribution of \$700,000 and a taxable amount of zero.

⁹⁹ In this instance, the trustee will issue a 2nd 1099R with a gross distribution of \$400,000 and a taxable amount of \$30,000.

basis in the shares distributed. This \$30,000 is considered ordinary unearned¹⁰⁰ income and is taxed at the regular graduated tax rates¹⁰¹. Further, John has \$50,000 of basis¹⁰² in 4000 shares of P&G with a market value on date of transfer of \$400,000; therefore John has net unrealized appreciation of \$350,000 on which no tax is due as John has not yet sold any shares.

In Path #2 John instructs his broker to immediately sell 2000 shares. Further, John elects by purchase lot to sell 1000 shares of the 3000 shares originating from his before tax account and all 1000 shares originating from his after tax account. This does result in two taxable transactions¹⁰³:

- (1) 1000 shares of P&G sold at \$100 for \$100,000 with a basis of \$10,000 resulting in a \$90,000 long-term capital gain. The tax due on this transaction will be \$13,500 (maximum 15% long-term capital gains tax rate). This gain is not considered to be ordinary income which would have created a tax due amount of \$22,500 or more. Essentially what has occurred here is the built-in gain of \$90 share has been converted from ordinary income to long-term capital gains thus saving John \$9000 in federal income tax by virtue of the different tax brackets.
- (2) 1000 shares of P&G is also sold at \$100 for \$100,000 with a basis of \$20,000 resulting in a long-term capital gain of \$80,000; tax due of \$12,000; savings \$8,000.

Path #3 gets a little trickier but is nonetheless logical. John does nothing on the date the shares are transferred and instead waits two months and sells all 4000 shares:

- (1) John is lucky and in the intervening two months P&G has risen to \$120 per share. Therefore John receives \$480,000 which results in \$430,000 of capital gains. However, the capital gains are split into two parts: \$350,000 is treated as long-term capital gain and \$80,000 of short-term capital gain representing the per share appreciation that has occurred

¹⁰⁰ This means that the \$30,000 is subject federal income tax but is not subject to FICA & Medicare taxes.

¹⁰¹ In this example, John is 56 in the year of his separation from P&G; therefore the \$30,000 is taxed as ordinary income. No additional taxes, penalties or interest are due. Were John to have been 54 or younger, in addition to treating the \$30,000 as ordinary income, John would also owe a \$3,000 (10%) early withdrawal penalty as required by IRC §72(t)(1). However, as will be described this may be a small price to pay depending on the level of appreciation in the securities.

¹⁰² At this point “basis”, \$50,000 in the example, is treated identically to “purchase cost” as in any other capital purchase transaction that one might enter into. More specifically, John has two purchase lots: 3000 shares with a basis of \$30,000 and 1000 shares with a basis of \$20,000.

¹⁰³ Both transactions described following would be reported as separate sales on Schedule D, Part II (for long-term gains) of the taxpayer’s Form 1040.

subsequent to the date of distribution¹⁰⁴.

- (2) John is unlucky and in the intervening two months P&G falls to \$80 per share. In this case John receives \$320,000 resulting in \$270,000 of capital gains. However, just as above, the capital gain is split into two parts: \$350,000 is treated as long-term capital gain and \$80,000 is treated as a short-term capital loss¹⁰⁵.

Path #4 is the easiest. John waits until any date after 2/3/05 and sells all 4000 shares at \$120 per share. John receives \$480,000 in proceeds from the sale and has a basis of \$50,000; therefore, John has \$430,000 of long-term capital gain all of which is treated as long-term capital gain; therefore the tax is \$64,500. By comparison had John not elected NUA treatment of the shares, all of gain on the sale of the shares would be treated as ordinary income resulting in a tax of \$107,500; \$43,000 more in federal income taxes.

In summary, electing NUA treatment for one's employer securities is almost always a good idea, particularly when the trustee's basis in the shares is materially less than the current market price of the shares. There are two circumstances where this may not be case: one, trustee basis and market price are close in value in which case it may or may not be to the benefit of taxpayer to essentially force a taxable event into an earlier tax year¹⁰⁶; two, the highest attained age of the employee is 54 or younger when he or she separates from the employer. In this case IRC §72(t)(1) will apply causing an extra 10% surtax on trustee's basis¹⁰⁷. When this occurs, all is not lost, rather the breakeven bar is simply raised a little, e.g. the conversion of income recognition from ordinary income at 25% to capital gains at 15% is often still worthwhile irrespective of the penalty¹⁰⁸.

¹⁰⁴ In this case, John would make four entries on Schedule D. Two entries would be made in Part II recognizing the long-term gains of \$270,000 and \$80,000; followed by two more entries in Part I recognizing short-term gains of \$60,000 and \$20,000, respectively.

¹⁰⁵ Similar to (1) above, John would make 4 entries on schedule D; the Part II entries remain identical, however, the part I entries become losses of \$60,000 and \$20,000, respectively.

¹⁰⁶ Remembering that using the NUA feature is an election, if there is no material appreciation in value of the security, then there is no conversion value from ordinary income to capital gain; therefore why not just liquidate the securities inside of the plan and transfer all of the cash proceeds to a rollover IRA account. This is why NUA elections are typically made on common stock and convertible debt as other employer securities typically have little or no opportunity for any material price appreciation.

¹⁰⁷ When discussing early distributions from a deferred account, we often talk about the age 59½ rule. However, when an ex-employee is withdrawing directly from an employer sponsored retirement account; e.g. §401(k), but not an IRA, IRC §72(t)(2)(A)(v) may apply which waives the 10% surtax on those withdrawals if the ex-employee separates from service from his or her employer in the same year as attaining age 55 or greater. The ex-employee need not actually be age 55 when separation occurs, simply attain age 55 by December 31st of the same year.

¹⁰⁸ In our case study above, John had \$350,000 in NUA which will be taxed, it is simply a matter of when. The shift from ordinary income to capital gains saves John \$35,000; therefore, even if

Finally, when evaluating NUA situations, one will typically find two kinds of situations: one, straight forward and easy circumstances coupled with a knowledgeable plan administrator who knows how to execute correctly; two, complex situations involving multiple classes of stock, account types and multiple plans traveling through successor organizations. In the former case, we suggest that taxpayers simply sign the withdrawal forms as there is little chance for error¹⁰⁹. In the later case, it is always prudent to pause and ask for help up to seeking a formal opinion letter from a qualified CPA or tax attorney before proceeding.

SUMMARY

In this chapter, we have covered two rather unique situations: Roths including their tremendous advantages and the basics of NUA treatment of employer equities. Further, we can quickly revert back to exception #5, Separation of Service at Age 55. All three of these situations have a common thread---**the need to look and plan ahead**, sometimes a couple of months, sometimes up to five years in advance. None of these exceptional situations are really difficult to implement although some, or the integration of one or more of these situations into an integrated whole financial plan may require a touch of professional help. More importantly, these situations are easy to miss and then become irrevocably lost the instant a taxpayer takes these assets and rolls them over into an IRA. This author's recommendation is that anyone contemplating retirement, actually at any age, should start the investigatory process at least one year in advance of the anticipated exit date. This then allows for a full examination of all the alternatives at a leisurely pace.

John were 54 resulting in a \$3,000 penalty tax, electing the NUA treatment would still be worthwhile.

¹⁰⁹ As is the case with almost all deferred account transactions; e.g. those governed by IRC §§401-424 & §72; errors need to avoided at all costs, even administrative ones, as there is usually little or no corrective mechanisms available to reverse / correct the error. As an example, if a plan administrator inadvertently distributes the "NUA elected" shares to the participant's IRA account instead of the participant's regular brokerage account (as should have occurred) and this error goes undetected, the participant has instantly lost his or her ability to elect NUA treatment. As a result, I would always advocate that all communications with the plan administrator / trustee be made in writing and all transactional results be verified quickly. In PLR 2004-42032 a trustee, acting on behalf of a separated plan participant, inadvertently distributed employer stock to the employee's IRA instead of his taxable account. Because more than 60 days had elapsed, the IRS ruled adversely & the employee lost the ability to elect the NUA treatment.

CHAPTER 4 - SUBSTANTIALLY EQUAL PERIODIC PAYMENTS

It would be convenient if a taxpayer could select any amount he or she desired and simply keep the withdrawal amount equal from year to year. Unfortunately, that is not the case. IRS Publication 590 provides some guidance; however, it is incomplete¹¹⁰. To quote in part, Publication 590 informs us that:

“You must use an IRS-approved distribution method and you must take at least one distribution annually for this exception to apply.

Publication 590

However, Publication 590 does not give us all the details we need. Instead we must refer to Revenue Ruling 2002-62¹¹¹ to get into the computational methods. Because computations are easiest to explain via example, we are going to build an assumed fact set for John Q. Taxpayer and use these facts consistently throughout the following examples.

- John is age 52 during 2003 and is married to Cathy, age 50 in 2003, who is his beneficiary.
- As of December 31, 2002, John has a total of \$1,000,000 in four rollover IRAs: A with \$400,000; B with \$300,000; C with \$200,000; and D with \$100,000.
- Although Cathy has deferred assets as well, she has elected not to make any early withdrawals.
- John terminated his employment with XYZ Corp. Effective December 31, 2002, and wishes to commence SEPPs in 2003 as an income replacement.
- For simplicity, neither John nor Cathy are disabled and neither will become deceased in the

¹¹⁰ Actually, for Publication 590 to use the language “must use” is incorrect, or at a minimum represents the IRS taking typical broad poetic license with its publications. Notice 89-25 gives us an affirmative statement: “payments will be considered to be...[SEPPs]...if they are made according to one of the methods...”. Similarly, Revenue Ruling 2002-62 says, in part: “Payments are considered to be...[SEPPs]...if they are made in accordance with one of the three calculations...”. Nowhere in the IRC or related authorities is there any language to the effect that there are only three acceptable methods to the exclusion of others or that some other methods are automatically disallowed. Thus, it is entirely possible that there are methods four, five and six which are equally acceptable

¹¹¹ See the Appendices for a complete reproduction of Revenue Ruling 2002-62.

next ten years.

THE MINIMUM METHOD

The minimum method is described in Revenue Ruling 2002-62 as follows:

“(a) The required minimum distribution 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. If this method is chosen, there will not be deemed to be a modification in the series of substantially equal periodic payments, even if the amount of payments changes from year to year, provided there is not a change to another method of determining the payments.”

Revenue Ruling 2002-62

Finally, some pretty straight-forward language. In order to implement the minimum method, John needs to make some decisions. First, John needs to determine “the account balance for the year”. In our example, this is \$1,000,000. Second, John needs to get a number from the “chosen life expectancy table¹¹²”. In this regard, John can pick one of three tables:

- The single life expectancy table.
- The joint and last survivor table.
- The uniform life table.

All three tables are published in the Appendices of this text¹¹³. There are several issues of note here: one, John must pick one of three and only three tables¹¹⁴; second, John must make his selection of the life expectancy table once and only once; he can not switch to another life expectancy table at a later date. Thus, John’s choices become:

¹¹² We will spend some time later in the text on life expectancy tables.

¹¹³ All three tables can also be found in Publication 590 as well as IRC Reg. §1.401(a)(9)-9, Q&A-1 & Q&A-3.

¹¹⁴ Unfortunately, Revenue Ruling 2002-62 is very explicit by saying: “The life expectancy tables that can be used...are...”. This leaves no room to select a table other than the three provided.

- The single life expectancy table --- 32.3.
- The joint and last survivor table --- 39.5.
- The uniform life table — 44.6.

The rest is simple division. John can distribute \$22,421.52 (using the uniform life table), \$30,959.75 (using the single life table) or \$25,316.46 (using the joint & last survivor table) in 2003. Moving forward, the minimum method requires annual recalculation. Let's assume for the moment that John selected the single life table and distributes \$30,959.75 during 2003. On December 31, 2003 he must recalculate to determine his 2004 distribution. Further, let's assume that John invested wisely such that his 12/31/03 IRA balances total \$1,060,000. John is now a year older (53) and his new divisor becomes 31.4; thus his 2004 distribution becomes \$33,757.96; up 9% from the year previous. This 9% increase has two components; one his IRA balances increased 6% from 12/31/02 to 12/31/03; secondly the divisor dropped from 32.3 to 31.4; a 2.8% decrease. This process of annual recalculation would continue until John (ignoring Cathy's age even when using the joint life expectancy table) and only John attains the age of 59½.

Advantages --- First, on the assumption that John is a reasonably astute investor, is that John will receive a "pay increase" each year by the virtue of the numerator increasing (by investment gains in excess of the amounts withdrawn) and the denominator decreasing (by virtue of the decreasing life expectancy(ies)). Second, the minimum method is designed to last a lifetime and statistically does so. As a result, John can sleep comfortably knowing that his assets will more than likely outlive himself.

Disadvantages --- First is that this method delivers relatively low annual distributions, in the range of 2.2% to 3.1% of assets, particularly at a time when John may need higher distributions. Second, annual recalculation is required, thus creating or inserting the concept of volatility. Based on John's investment decisions as well as market performance may result in future year annual distributions that are materially smaller or larger than John anticipates or wants. Third, although not a major issue, annual recalculation does require the careful scrutiny of IRA documents (potentially from multiple trustees) and recomputation of life expectancies. Although not particularly difficult in a mathematical sense, the potential for error exists, which could result in an incorrect mathematical result¹¹⁵.

¹¹⁵ This author has found no ruling or other circumstance where the taxpayer was dutifully following this method and made a mathematical error resulting in a subsequent year incorrect distribution amount. On its face, such an amount would fall outside the umbrella of deemed substantially equal. What the IRS might do is unknown. Still there is no reason to tempt fate; every taxpayer should re-check his or her math twice, if not three times.

THE FIXED AMORTIZATION METHOD

Again, Revenue Ruling 2002-62 gives us a concise definition:

“(b) The fixed 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. Under his method, the account balance, the number from the chosen life expectancy table and the resulting annual payment are determined once for the first distribution year and the annual payment is the same amount in each succeeding year.”

Revenue Ruling 2002-62

With the amortization method, John is faced with three decisions. First, John must determine his account balance (we will assume the same \$1,000,000); second, John must pick a life expectancy (again, the same three expectancies of 44.6, 32.3 and 39.5 are available). Third, John must pick an interest rate. In this regard, revenue Ruling 2002-62 gives us additional explicit guidance¹¹⁶:

“The interest rate that may be used is any interest 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).

Revenue Ruling 2002-62

Applicable federal rates are published monthly, usually toward the end of each month and can be found in a variety of Internet¹¹⁷ and print locations. In our instance, let's further assume that John wants to commence monthly distributions in January, 2003; therefore the mid-term applicable federal rates for November and December of 2002 are 3.06% and 3.31% respectively. John's next step is to select the higher of two (3.31%) and multiply by 120% resulting in 3.972% (3.31 * 1.2) as the maximum interest rate John can use. Notice that this is a one-sided test only creating a maximum allowable interest rate. Any interest rate less than 3.972% is fine, right down to zero percent if desired.

¹¹⁶ Readers of earlier editions of this text will recall that interest rate guidance was pretty vague in 2002 and earlier with language that said: "...at an interest rate that does not exceed a reasonable interest rate on the date payments commence...". No longer; interest rates are now very specifically capped.

¹¹⁷ Try www.timevalue.com or www.72t.net. Or, to be up to the moment, visit the official IRS website at www.irs.gov/tax_regs/fedrates.html.

Assuming John selects from the single life table, we now have all the factors necessary: \$1,000,000 of principal, 3.972% and a term of 32.3 years. Let's amortize. The easy way to perform the mathematics is to use Lotus, Excel or any other computer based spreadsheet product¹¹⁸ using the formula: @PMT(P,I,T) where "P" is the principal amount, "I" is the interest rate and "T" is the term. Thus, we would express this as: @PMT(1000000,.03972,32.3) resulting in \$55,489.16 per year. John's monthly distribution would be \$4,624.10 (\$55,489.16 / 12).

What we have just computed above is **THE MAXIMUM** allowable annual distribution using the amortization method. At a zero interest rate assumption, the annual distribution would fall to \$30,959.75; the same as the minimum method using single life expectancy. As a result, John can reasonably select **ANY** annual distribution amount between \$30,959.75 and \$55,489.16 simply by selecting an interest rate that causes the mathematics to perform correctly to his wishes. As an example, suppose John wanted exactly \$3,000.00 per month. Using the @PMT function, John can back-solve for the needed interest rate of .93268% which will result in exactly \$36,000 per year.

The amortization method is a one time computation performed before the first distribution is made and is held constant throughout the SEPP program.

Advantages --- First and foremost, the amortization method yields substantially higher annual distribution amounts than the minimum method. In our example, almost an 80% increase. Further, as of this writing, we are in a period of historically low interest rates which are accordingly reflected in the published applicable federal rates. If 120% of mid-term rate were 6.5% (as recent as the Winter of 2001), the annual maximum distribution would jump upwards to almost \$75,000 per year. Second, the amortization method is variable in its application; John can pick any annual distribution amount he so chooses as long as it is equal to or less than the maximum computed; conversely, the minimum method produced only "fixed point" amounts depending on which life expectancy table was chosen. Third, the amortization method mathematics are done once thus removing the possibilities of mathematical error and potentially unwanted volatility in annual distribution amounts.

Disadvantages --- On the other hand, the amortization method does not provide the built in pay increases found in the minimum method. Secondly, there is the risk that John, through unwise investments and/or poor market performance, may prematurely exhaust or materially deplete his IRAs such that the prospect of those IRAs providing lifetime income are seriously diminished.

¹¹⁸ For those individuals with no access to an electronic spreadsheet product, the same can be accomplished using any financial series hand-held calculator made by Texas Instruments, Hewlett-Packard and others.

THE FIXED ANNUITY METHOD

The annuity method is also described in Revenue Ruling 2002-62 as follows:

“(c) The fixed 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. Under this method, the account balance, the annuity factor, the chosen interest rate and the resulting annual payment are determined once for the first distribution year and the annual payment is the same amount in each succeeding year.”

Revenue Ruling 2002-62

Many readers may wish to skip the next three to four pages for several reasons:

- Commencing January 1, 2003 (as opposed to earlier) the IRS forced conformity in the selection of life expectancy tables. Use of a more aggressive¹¹⁹ mortality table was the major advantage of the annuitization method over the amortization method typically resulting in annual distributions being 5% to 10% higher with the annuitization method. No longer. Now, with life expectancy tables fixed, the annuitization method always yields an annual distribution which is just slightly less than the amortization method. As a result, this author can think of no reason to use the annuitization method. Instead, the amortization method is always preferable and there are other tactics that can be employed if reducing the annual distribution is an objective.
- The annuitization is packed with some not so easy to understand higher mathematics.

All of the above is a “moderately-winded” way of saying, don’t bother? Nonetheless, because the new ruling specifically approves this method, we will cover it as well.

What’s an “annuity factor”? Do you; (a) buy it, (b) bake or (c) build it? My apologies to the mathematically adverse or impaired --- the answer is (c) we build it. However, for those of you who have no interest in building the spreadsheet, please skip to the end of this chapter¹²⁰ For those readers who are mathematically adept or just want to make absolutely sure, we are going to devote the next several

¹¹⁹ “Aggressive” in the sense that more people die earlier; thus, the annuitant divisor computed from that mortality table is smaller thus resulting in a higher annual distribution.

¹²⁰ This author suspects that there are a dozen or more web sites which have annuitant divisor calculators pre-built and ready for one’s use. Two of which are known to be accurate and correct are located at: www.retireearlyhomepage.com and www.72t.net.

pages to describing how to build an annuitant divisor table. We necessarily start with Appendix B of Revenue Ruling 2002-62 “Mortality Table Used to Formulate the Single Life Table in §1.401(a)(9)-9, Q&A-1¹²¹. Following is an excerpt:

Age	% Deaths	Population	Deaths
51	.2646	964,348	2,552
52	.2896	961,796	2,785
53	.3167	959,011	3,037

Remember that John is age 52 in 2003. According to this table, there are 961,796 people just like John. Of those, 959,011 will make it to their 53rd birthday, 2,785 of them will die. Thus, .2896% of 52 year-olds will expire before attaining age 53. Conversely, 99.7104% of all 52 year-olds will survive one more year. So, in order to convert a mortality table into an annuitant divisor table we need to add some columns:

Col A- Age	Col B -Q _x	Col C-L _x	Col D- Comp	Col E -	Col F - Prob. Of Living After Age	Col G - NPV of	Col H - Annuitant
51	.2646	964,348	.2646	0.000	0.0000	0.0000	0.0000
52	.2896	961,796	.2896	0.000	1.0000	1.0000	1.0000
53	.3167	959,011	.3167	0.000	0.9971	0.9524	0.9496
54	.3453	955,974	.3453	0.000	0.9939	0.9070	0.9015
					Sum to Age 115	20.0751	16.0591

Let’s walk through these columns one at a time to see what’s happening:

- Column A --- Ages from 0 to 115 directly from the mortality table.
- Column B --- Probability of death before attaining the next age, Q_x, again directly from the mortality table.

¹²¹ Effective 1/1/03, this mortality table is the only allowed mortality table to be used in construction of an annuitant divisor table. Prior to 1/1/03, as earlier edition readers will remember, upwards of nine different mortality tables were allowed.

- Column C --- The beginning population of the age, L_x , again directly from the mortality table.
- Column D --- Computed as $[(\text{Col C, Row X}) - (\text{Col C, Row X+1})] / (\text{Col C, Row X})$.
- Column E --- Column B minus Column D. What we are doing in Column D & E are simply rechecking the IRS's math
- Column F --- Is the probability of continuing to live past one's currently attained age. Because John is 52, we can express this algebraically as "If Col A = 52, put a 1 here; else, if Col A < 52, put a zero here, else, put a number here equal to $(1 - \text{Col B}) * (\text{Col F, up one relative row})$ ". What's going on here? We want this column to be zero for all ages under 52 because John has already successfully passed through those ages. Further, if John is age 52, then he has a 100% probability of attaining that age because he is that age, thus the 1. For any age above 52, John has a probability of living to that age of less than 100% that is equal to $(1 - \text{Col B})$ the percent of deaths for that age times the probability of attaining the immediately previous age.
- Column G --- Net present value of a \$1 at the chosen interest rate. In this example we have assumed 5%. The formula for this cell can be expressed as: If Col A = 52, put a 1 here, else, if Col A < 52, put a zero here, else put a value here equal to $(1 / (1 + .05)) * \text{the value of Col G up one relative row}$.

Essentially, because John is age 52, the value of \$1 is worth \$1 this year. However, the value of \$1 one year from now is worth less than \$1. It is worth only $\$1/(1.05)$ or approximately 95.2 cents. Two years from now that \$1 is worth only $\$1/(1.05)^2$ or approximately 90.7 cents, and so forth.

- Column H --- Is the annuitant factor for one year expressed as Column F times Column G. The sum of Column H from age 52 to 115 is the annuitant divisor, in this case 16.0591. Further, as John ages up, let's say three more years to age 55, the divisor will get marginally smaller to 15.4362.

Remembering that the maximum allowable interest rate for January, 2003 was 3.972; this creates an annuitant divisor of 18.1497; thus a maximum allowable annual distribution of \$55,097.26 ($\$1,000,000$ divided by 18.1497). This is close to, but less than the \$55,489.16 maximum allowable using the amortization method.

This author has tested many, but not all intersects of age and interest rates. In all cases tested, the amortization method always yields a slightly larger maximum annual distribution than the annuitization method. Thus, this author sees no value in adopting the annuitization method for several

reasons¹²²: one, a higher annual distribution can always be achieved using the amortization method; two, if a lower annual distribution is desired, there are better ways to do it as we will discuss in later chapters; three, the annuitization method is just plain more difficult to understand and compute.

OTHER METHODS & LIFE EXPECTANCY TABLES

As of this writing, there are only the three methods discussed above which are allowed¹²³. However, that does not necessarily mean that there will not be other methods allowed in the future. As an example, John might very specifically want to completely exhaust his total IRA before age 70¹²⁴.

In prior editions of this guide, we spent a whole chapter on life expectancy tables. Pre-1/1/03, these tables were important with nine specifically approved tables, two more semi-approved¹²⁵ and potentially several dozens more all published by private insurance companies. No more. Revenue Ruling 2002-62 tells us, very explicitly, that a taxpayer must choose one of three tables:

- First is the Single Life table¹²⁶. This table will always produce the lowest life expectancy divisor of all three tables. Thus, if one wishes to maximize the computed annual SEPP distributions holding the IRA dollars at work constant, this is the table to use. All taxpayers are eligible to use this table, even married taxpayers.
- Second is the Joint & Last Survivor table¹²⁷. This table will always yield a life expectancy divisor larger than Table I above and is specifically based on the your age plus the age of

¹²² As readers of earlier editions may recall, this was not always the case. Prior to 1/1/03 the annuitization method most often created the largest annual distribution through the use of mortality tables permissible under that annuitization method that were not allowed under the amortization method. Unfortunately, this is no longer the case now that the mortality table for both methods is fixed.

¹²³ A little later in the text we will discuss “annual recalculation” using the amortization method. One can think of this as a 4th method or simply an alternate interpretation of the fixed amortization method.

¹²⁴ John’s family has a long history of short-lived males and John wishes to completely exhaust his IRAs quickly, leaving only regular after-tax assets (which receive a step up in basis upon his death) to his heirs.

¹²⁵ These were the infamous Table S’s based on the 80CNMST and 90CM mortality tables respectively developed from the 1980 and 1990 censuses.

¹²⁶ See IRC Reg. §1.401(a)(9)-9, Q&A-1, or Table 1 of Publication 590 or the Appendices to this guide.

¹²⁷ See IRC Reg. §1.401(a)(9)-9, Q&A-3 or Table II of Publication 590 or the Appendices of this guide.

your beneficiary. All taxpayers are eligible to use this table.

- Third is the Uniform table¹²⁸. The uniform table is the same as the joint & last survivor table assuming a beneficiary who is ten years younger than you are. Thus, if your objective were to minimize the annual distribution and your beneficiary is either older than you are or is less than ten years younger, you would use this table.

As of mid-2004, the tables described above as well as reproduced in the Appendices are the only tables permitted. However, this may not always be the case in 2005 and beyond. The Service may add tables or may revise the existing ones at its discretion. Therefore, all taxpayers should visit www.irs.gov at least once a year going forward and download Publication 590 and any of its then supplements to get the current tables.

INTEREST RATES

Pre-12/31/02, interest rate selection was a wide open ball game & by some professional thinking, a major contributor to “bankrupt” SEPP plans; e.g. plans where the corpus of the IRA has so materially declined that a hopeless situation now existed in terms of the annual distributions lasting until the taxpayer’s 59 ½ birthday; much less for the taxpayer’s remaining expected lifetime. Notice 89-25 told us: “at an interest rate that does not exceed a reasonable interest on the date payments commence”. The Notice went on to use examples of 8%. As a result, there were numerous private letter rulings in the 1990 to 2000 era using a variety of interest assumptions ranging from 6% all the way up to 10.6%. Now, with the advent of Revenue Ruling 2002-62; taxpayers are limited (but only on the high side) to a maximum interest rate assumption equal to (or less than) 120% of the mid-term applicable federal rate from either of the two months preceding the month of the first actual distribution. If we look, for a moment at mid-term applicable federal rates, we see that they have ranged from a high of 6.85% (mid-1996) to a low of 2.55% (mid-2003). Correspondingly, 120% of the mid-term applicable federal rates have ranged from 8.2% to 3.1% at those same dates.

Does use of a 3.1% or an 8.2% interest rate assumption make sense? This author would suggest that neither interest rate assumption makes sense; in fact, no interest rate assumption makes sense. Instead, what’s really important is the portfolio withdrawal rate! Let’s assume a 50 year old taxpayer. Further, let’s presume that the U.S. Census Bureau is correct and the life expectancy of a 50 year old really is 34.2 years. Lastly, let’s assume that we generally believe all of the “safe withdrawal rate” studies¹²⁹ that basically indicate that any withdrawal rate north of 6% has an increasingly higher probability of failure and that the “safe” rates generally lay in the 4% to 5% range. Our taxpayer wants his annual withdrawals to last his lifetime and must make a interest rate assumption; Revenue Ruling 2002-62 gives him no other alternative. The table below says he should pick an interest rate no higher than 3.5% and would be safer

¹²⁸ See Revenue Ruling 2002-62, Appendix A, page 8 or Publication 590 Table III or the Appendices to this guide.

¹²⁹ Drop “Trinity” or “Ibbotson” into any Internet search engine and take a look.

to choose in the low 3% range. Further, based on the mechanics of the amortization formula, older taxpayers should actually choose lower interest rates in order to keep the portfolio withdrawal rate under 5%; e.g. a 56 year old should actually use an interest rate around 2.75% to keep his withdrawal rate in the safe range.

**Amortization Method Annual Withdrawal Rates
At varying Ages and Interest Assumptions**

Age	50	51	52	53	54	55	56
Life Expectancy	34.2	33.3	32.3	31.4	30.5	29.6	28.7

3.00%	4.72%	4.79%	4.88%	4.96%	5.05%	5.14%	5.25%
3.50%	5.06%	5.13%	5.22%	5.30%	5.39%	5.48%	5.58%
4.00%	5.42%	5.49%	5.57%	5.65%	5.73%	5.82%	5.92%
4.50%	5.78%	5.85%	5.93%	6.01%	6.09%	6.18%	6.27%
5.00%	6.16%	6.23%	6.30%	6.38%	6.46%	6.54%	6.64%
5.50%	6.55%	6.61%	6.69%	6.76%	6.84%	6.92%	7.01%
6.00%	6.95%	7.01%	7.08%	7.15%	7.22%	7.30%	7.39%
6.50%	7.35%	7.41%	7.48%	7.54%	7.62%	7.69%	7.78%
7.00%	7.77%	7.82%	7.89%	7.95%	8.02%	8.09%	8.17%
7.50%	8.19%	8.24%	8.30%	8.36%	8.43%	8.50%	8.58%
8.00%	8.62%	8.67%	8.73%	8.78%	8.85%	8.91%	8.99%
8.50%	9.06%	9.10%	9.16%	9.21%	9.27%	9.33%	9.40%
9.00%	9.50%	9.54%	9.59%	9.64%	9.70%	9.76%	9.83%

As of this 4th edition, 120% of the mid-term applicable federal rate was approximately 4.5%, give or take 25 - 30 basis points. Therefore, taxpayers electing the maximum allowable rate are looking at 5.78% to 6.27% withdrawal rates; in this author's opinion, right on the upper edge of sanity. Two years from now, when 120% of the mid-term applicable federal rate is 7% should the average taxpayer use it resulting in an approximate 8% portfolio withdrawal rate? Maybe, maybe not. Let's look at two situations:

- (1) Bob is 50 and his only material investment asset is his IRA & therefore needs to structure a SEPP plan to last his lifetime. Further, he is of the belief that social security will exist 12 years into his future but will do little more than provide a cost-of-living increase at that time. We would suggest that Bob forget about maximum interest rate assumptions and instead look to the table above and select an interest rate in the 2.5% to

3.5 % range resulting in a portfolio withdrawal rate in the 4% to 5% range.

- (2) Fred is also 50 but really has two assets; his IRA and a defined benefit pension that will commence at 60 thus permitting him to reduce his IRA withdrawals by 50% or more ten years in the future. Further, Fred is also trying to accumulate some extra after-tax cash to pay for some college educations in the near future. Here we would suggest that Fred “swing from the heels” selecting the maximum allowable interest rate. In contrast to Bob, Fred is really designing a limited term cash flow plan within the guise of a SEPP program; not a lifetime withdrawal plan.

Unfortunately, Revenue Ruling 2002-62 was written as a “one size fits all” set of rules which actually creates two different sets of risks: Bob can potentially over-withdraw and over-spend in earlier years potentially resulting in a later year situation of running out of assets. Conversely, Fred is “interest rate capped” and can not get enough money out quickly enough to meet his plans. This author has long labored with the IRS for a solution to this dilemma without success. There is no current solution and there is unlikely to be one in the near to intermediate term.

CHAPTER 5 - ACCOUNT EXHAUSTION & METHOD CHANGES

Up until October, 2002, everyone in the tax community was rightfully concerned that prematurely exhausting one's IRA account exposed oneself to the retroactive imposition of the 10% surtax plus interest. No longer. Revenue Ruling 2002-62 did bring some welcome relief to taxpayers who had launched SEPP programs in the 90's and were now facing some dire circumstances of early and over-depleted IRA assets. Now, taxpayers have some SEPP plan exit strategies that avoid 100% of the surtax and related interest charges.

ACCOUNT EXHAUSTION

Revenue Ruling 2002-62 says in part:

“(a) Complete depletion of assets. If, as a result of following an acceptable method of determining substantially equal periodic payments, an individual's assets in an individual account plan or an IRA are exhausted, the individual will not be subject to additional income tax under §72(t)(1) as a result of not receiving substantially equal periodic payments and the resulting cessation of payments will not be treated as a modification of the series of payments.”

Revenue Ruling 2002-62

What does the above really say? It says that no matter when you run out of money in your IRA and therefore stop distributions, no penalties or interest will apply. This is extremely good news; but for the obvious, which is that your IRA has run out of money. However, there are some rules which must be followed:

- The SEPP plan which you are currently following, presumably designed some years past, was, at that time, an “acceptable method”. How do you know if your method / plan was acceptable? Hopefully, you documented your plan specifics some years ago and may even have an opinion letter from a tax accountant, CPA or attorney. All of these are evidence of acceptable methods.
- The IRA account(s) from which SEPPs are being performed **MUST BE 100% EXHAUSTED**¹³⁰. Notice the first word in the excerpt above: “complete”. Less than

¹³⁰ Recently, a “phoenix from the ashes” circumstance has been under study. What if a taxpayer exhausted their account in 2003 and further made a less than planned distribution in 2003 to cause the account balance at 12/31/03 to be zero? However, to achieve that zero balance at 12/31/03, the IRA trustee valued a non-performing asset that remained in the account at zero and subsequently, say in 2004, that asset (maybe a bond in bankruptcy) starts to once again perform;

100% does not qualify. Therefore, to avail oneself of this option, make absolutely sure that all assets are distributed from the IRA, right down to the last penny. Leaving \$1 or \$123 in the IRA account would theoretically disallow this treatment, thus reimposing the 10% surtax and interest.

METHOD CHANGES

As a general rule, all method changes are considered “modifications” thus imposing the 10% surtax plus interest. However, the new revenue ruling has provided a second “one time escape” mechanism for taxpayers who have an existing SEPP plan and want to materially reduce their annual distributions going forward.

“(b) One-time change to required minimum distribution method. An individual who begins distributions in a year using either the fixed amortization method or the fixed annuitization method may in any subsequent year switch to the required minimum distribution method to determine the payment for the year of the switch and all subsequent years and the change in method will not be treated as a modification within the meaning of §72(t)(4). Once a change is made under this paragraph, the required minimum distribution must be followed in all subsequent years. Any subsequent change will be a modification for purposes of §72(t)(4).”

“If a series of payments commenced in a year prior to 2003 that satisfied §72(t)(2)(A)(iv), the method of calculating the payments in the series is permitted to be changed at any time to the required minimum distribution method described in section 2.01(a) of this guidance, including use of a different life expectancy table.”

Revenue Ruling 2002-62

An individual who began distributions using either the fixed amortization or fixed annuity method may switch to the “required minimum distribution” (RMD) method and the change in method will not be considered a modification; thus no penalties or interest. This represents a terrific planning opportunity in that it is open ended and need not be exercised within any specific time frame; however, once elected, it is “cast in stone”, e.g. taxpayers only get to make this election once and then must stick with it. Again, some observations:

starts paying again; receives liquidation proceeds, etc. Did the IRA really have a zero balance at 12/31/03? Was the IRA completely exhausted? The answer is we do not know. There have been no rulings or other pronouncements from the IRS to help us in creating standards to test this situation. As a result, this then represents a situation to potentially be avoided for taxpayers planning on the launch of SEPP plans.

- First, let's look at the math by way of an example. Assume Bob, a 50 year old commenced SEPPs in 1998 starting with \$1,000,000 in his IRA and distributed \$75,000 per year in 1998 through 2002 and now has \$400,000 left (\$375,000 in distributions and \$225,000 in market losses). Commencing in 2003 Bob will be 55. Assuming Bob is married with a same-aged spouse, he will have three tables to choose from: the new Uniform Lifetime Table, resulting a divisor of 41.6; the joint & survivor table, resulting in a divisor of 35.6, or the single life expectancy table resulting in a divisor of 29.6. As a result, Bob can take a distribution in 2003 of either \$9,615, \$11,236 or \$13,514. Admittedly, these distribution amounts are materially lower than Bob took in earlier years of \$75,000 per year; nonetheless, Bob may already be in the process of restructuring his financial affairs such that this type of method conversion may fit.
- If Bob chooses to make this method switch, it is an irrevocable one time election that may not be reversed. Further, Bob must stick with the same life expectancy table originally chosen and must recalculate every year using an updated account balance and an updated life expectancy divisor based on his new age.
- Bob might be, so to speak "on the cusp" in that he has \$400,000 remaining in his IRA and basically has six years to go, or \$450,000 of future distributions. Maybe his IRA will make it, maybe it won't. Thus, Bob, really has three choices:
 - Maintain the old method distributing \$75,000 per year. If the IRA makes it, great; if not, Bob avails himself of the new "account exhaustion" exception as discussed above resulting in no penalties or interest.
 - Bob continues the old method of distributing \$75,000 per year for a while either watching and waiting for some market turn around and / or providing himself a time window to restructure his other financial affairs and switches to the RMD method in 2004 or later.
 - Bob immediately switches to the RMD method as described above.

The above example is rather simplistic and each taxpayer's individual facts & circumstances are, by definition, different & likely more complex. However, each taxpayer is encouraged to seek competent assistance (which may be yourself with a spreadsheet) to work through all of the alternatives to see which scenario fits best for you.

Lastly, distributions in the range of \$9,600 to \$13,500 can be considered a disaster to some one accustomed to taking \$75,000 per year. The common complaint or question: "Is there no way to strike a middle solution, like \$40,000 or \$45,000 per year?" For those taxpayers who have already launched SEPP plans against a single IRA in prior years, the answer is unfortunately no. For those taxpayers who had the presence of mind to split their IRAs before commencing a SEPP plan; their choices are multiple such as simultaneously converting to the RMD method one IRA #1 and launching a new SEPP plan on IRA #2 to take up the slack.

MID-YEAR METHOD CHANGE

Why not? After all, the new ruling does say “at any time”. The real key to making a method change from an existing amortization/annuitization method to the required minimum distribution method, is to think through your financial issues and plan prospectively. Looking at Bob above, he might decide that the optimal time to perform a method switch is on June 30, 2005. Bob came to this conclusion by analyzing, in advance, a variety of factors: his age now and in 2005; growth or lack thereof planned for his other assets; planned changes in lifestyle; ability to accumulate after-tax assets between now and mid-2005. In short, Bob has prospectively built a financial model of himself for the next several years; at least until 2008 when Bob will turn 59 ½ and he has come to the informed conclusion that June, 2005 is the right time for him to perform a method switch. Further, he has the next 30 months or so to continue to refine his decision-making as well as monitor progress against his estimates and expectations.

Let’s assume all progresses well and it is now January 1, 2005, Bob is will soon turn 57 and has continued his \$75,000 per year distributions under his old plan. Lastly, Bob has been rather astute in his investing such that his 12/31/04 IRA balance is \$350,000. Bob is still on target for his method switch effective July 1, 2005. What should he do?

- 1st Bob should make exactly ½ his normal annual distribution, \$37,500, sometime between 1/1/05 and 6/30/05.
- 2nd value his account as of 6/30/05. Let’s assume his IRA decreased in value to \$300,000.
- 3rd compute his RMD method distribution at \$10,752.69 (\$300,000 divided by 27.9, the life expectancy using the single life table).
- 4th distribute exactly ½ of the RMD method amount, \$5,376.44 sometime between 7/1/05 and 12/31/05.
- 5th value his account again on 12/31/05 dividing by 27.0 (the factor for a 58 year old) to arrive at his total annual RMD distribution for 2006.

In the above manner, Bob has created a prorata division of the 2005 year; in this case, treating exactly ½ the year under the old method and ½ the year under the new method. Bob could have easily decided to treat 9 months under the old method and 3 months under the RMD method. Most importantly, Bob planned in advance. Had he not done so and distributed all \$75,000, say in March, 2005; he would be stuck with having distributed too many dollars in 2005 with no way to put

the excess dollars back in the IRA account¹³¹.

¹³¹ This is not entirely true. Bob might be able to apply for an exception under Revenue Ruling 2003-16 in order to be permitted to put some money back in his IRA. However, this author likes planning a whole lot better than relying on the graciousness of the IRS in order to obtain an exception.

CHAPTER 6 - OTHER PLANNING ISSUES

Someone once said success or winning is in the details. In this author's opinion, no truer words could be spoken regarding the planning of SEPPs. Thus far we have covered a lot of ground discussing all of the relevant authorities and general concepts as well as the computational specifics of all three methods. Now, we need to put all this together to effectively plan a SEPP program. But, before we can do that, there are a variety of tactical planning topics that require some coverage. What follows are planning tips. Sometimes these tips are obvious and simply need repeating within the context of a SEPP. Usually, these tips are founded in other sections of the IRC or related documents of authority. Other times, these planning tips are the author's opinion combining established authority and patterns in the PLRs with in-depth experience on the subject.

HOW TO PLAN A SEPP

This author's opinion is that SEPPs should be planned in reverse. Step one should be to quickly use the amortization method with a maximum allowable interest rate based on the sum of your IRA balances to arrive at a theoretical maximum annual distribution. This a quick "back-of-the-envelope" calculation to determine a reasonable upper limit. Using John again, age 52, with \$1,000,000 in IRAs and an interest rate assumption of 4% we can quickly learn that his theoretical maximum annual distribution approximates \$55,000 per annum. John may have already decided that he needs \$75,000 to \$80,000 per year for the next eight years. Maybe by pushing the edge of the envelope, we can increase his SEPPs to \$60,000, but we can not get them to \$75,000. John should stop right here and reassess his living needs or delay program implementation.

As a second example, let's assume John has decided that he needs \$45,000 per year for the first four years and \$60,000 per year for years five through eight (the increase attributable to John Jr.'s college tuition). Now we have something to work with --- a set of cash flow expectations that are under the upper limit. For the moment, let's forget about methods, interest rate ceilings and so forth. Instead, John should put all his energies into mapping out his detailed cash flow needs in as much detail as possible. This implies some budgeting for both regular living needs as well as planned capital expenditures, maybe tuition or elder care, as well as some kind of emergency fund.

Once we have future cash flows figured out, planning SEPPs is really rather easy. Whenever possible, we make the SEPPs fit the cash flow needs, not the other way around. What follows are simply a set of tactical formation tools that will allow you to custom tailor a SEPP program or series of SEPP programs to fit your needs.

ACCOUNT FRACTURING & AGGREGATION

All of our previous examples have focused on a single IRA with a single balance. This is fine for example purposes, but poorly reflects real life. More often than not, a taxpayer will have a whole collection of deferred accounts with wide-ranging values. The IRC is very clear on the subject of account fracturing (one into many) and account aggregation (many into one). As long as the IRAs are moving between or within approved trustees, anything is game. John can have four IRAs or forty (by fracturing) or twenty-one by combining the last twenty into one (through aggregation). Thus, how do we interpret and use these rules in light of our desire to create one or more SEPP programs?

- First, all account fracturing¹³² or aggregation relative to the IRA accounts to be used for the SEPP program must be completed before the first SEPP withdrawal is made. This effectively defines the IRA account universe from which SEPPs will be performed.
- Second, once the first SEPP distribution has occurred, the account universe (which can be one or several deferred accounts) is cast in concrete for the duration of the SEPP program. Accounts within the universe must stay inside the universe & can not leave. Similarly, accounts outside the universe can not enter. Another way to think about this is that the only cash transactions permitted within the account universe are the periodic withdrawal transactions. To add an account after the first withdrawal transaction effectively looks like account replenishment which is specifically prohibited¹³³; to remove an account almost looks like a withdrawal of sorts and thus a modification.
- Third, and conveniently, any fracturing or aggregation of other non-SEPP IRA accounts can be left for a future date.
- Fourth, and potentially the most important, one must strike a balance between committing assets to the account universe in order to receive the SEPP distributions versus holding some IRA account assets outside the account universe (housed in separate IRAs) for future needs and/or risk exposure.

MULTIPLE SEPP PROGRAMS¹³⁴

Why not? An excellent tactical move for John is commence SEPP program #1 immediately to provide his base needs of \$45,000 per year and commence SEPP program #2 four years in the future to cover the college tuition payments. What are the rules to make this work effectively?

- The account universes for program #1 and program #2 must be discrete; meaning that they may not overlap, and must remain so for the duration of the SEPP programs.
- SEPP withdrawal dollars for program #1 must be withdrawn from one or more of the accounts within universe #1 and similarly SEPP withdrawal dollars for program #2 must be withdrawn from one or more of the accounts within universe #2. Cash

¹³² In one of the few adverse PLRs, in 97-05033, the Service ruled: “the entire account balance in each of the pertinent IRAs must be taken into account. That is, a portion of one or more of the IRAs may not be excluded in order to limit the periodic payment to a predetermined amount.” The ruling itself is very clear. What is unclear is whether the taxpayer had intended to fracture one of his IRAs before commencing his SEPPs and simply neglected to do so, or whether his independent advisor simply made and interpretive or mathematical error. Nonetheless, the ruling is very clear; get all of your account fracturing done before the first withdrawal.

¹³³ See Revenue Ruling 2002-62, .02(e)(I).

¹³⁴ See PLR 98-12038.

transactions which cross between the universes are not permitted and would have the effect of causing a modification to both SEPP programs.

- SEPP program #1 and program #2 are completely independent of each other. Thus, as an example, program #1 can start using the amortization method using 4% at age 52 and program #2 can commence four years later using the RMD method.

IMPORTANT DATES

There are a variety of calendar dates that are important: your birthday; your SEPP starting date, as defined by the date of the first cash distribution; and account valuation dates. Each of these dates are important for different reasons. Further, these dates actually have little relative importance in computing the dollar amount of SEPPs, but they are all administratively critical; e.g. date errors are easy to make and have a small, but real, possibility of invalidating a SEPP program.

Unless otherwise specifically noted, IRC §§401-416 and §72 always use the concept of “highest attained age within a tax year”. As an example, if your birthday is 6/30/50 and today is 6/29/00, we all know that you are 49 and one day later you will be 50. However, should you commence a SEPP program anytime in 2000, you are considered to be 50 for program design purposes as 50 is your highest attained age within the tax year 2000.

SEPP programs must continue for a minimum of five years. When do we start counting and how do we count? A SEPP program’s start date is the calendar date of the first withdrawal transaction from one or more of the accounts defined in the SEPP universe. From that date, we literally add 1828 days.¹³⁵ 1828 is 365 times 5 plus the potential for two leap years; plus one day for insurance. Alternatively, if the first SEPP distribution occurred on 3/15/00; then the ending date for the SEPP program becomes 3/15/05. As a result, during the intervening five years, the only allowable cash transactions are those which are the SEPP distributions¹³⁶.

Accounts can technically be valued on any date, However, as an administrative matter of proving up a valuation, this author always suggests that month-ends be used. A document prepared by an external body, e.g. your brokerage firm is always nice to have in your files should anyone ever

¹³⁵ Remember the *Arnold v. Commissioner* case (111 TC 250; 1998 U. S. Tax Ct.). In this case, the Court sided with the IRS in a literal interpretation of the IRC that five years was indeed the effective equivalent of 1828 days. Although it has never been litigated, the same question would apply to determining when a taxpayer turns 59 ½. Because we are discussing the interpretation of the IRC and not some IRS announcement of some kind, it is the author’s opinion that the safest interpretation is a literal one: adding 183 days to one’s 59th birthday.

¹³⁶ As a result of this, it becomes very prudent for a taxpayer to consider fracturing their IRA before commencing SEPPs into two IRAs: A & B, fully intending to only make SEPP distributions from IRA A. Then should an unforeseen event occur requiring a quick infusion of cash; that unforeseen emergency can be handled from IRA B. As a result, regular income taxes and the 10% penalty would be due on the distributions from IRA B. Not necessarily the most desirable event in the world but better to pay the penalty on IRA B distributions alone than to pay the penalties on all the distributions made from IRA A as well.

ask how you arrived at a dollar valuation for an account.

SEPPs, in addition to running for five full years, must also continue until you attain your 59 ½ birthday. Not surprisingly, you attain your 59 ½ birthday exactly 183 days after your 59th birthday.

In order to completely satisfy the §72(t) rules, SEPPs must continue for at least five full years and until you attain the age of 59 ½. You will know your SEPP start date --- write it down. You can easily compute the SEPP start date plus five full years as well as compute your 59 ½ birthday. Use the later of these two dates and discard the earlier. When executing transactions in your IRA, simply insure that the only cash transactions are the SEPP transactions between these two dates.

ACCOUNT VALUATION DATES

Revenue Ruling 2002-62 has some rather interesting¹³⁷ language on this subject. It says:

“(d) Account balance. The account balance that is used to determine payments must be determined in a reasonable manner based on the facts and circumstances. For example, for an IRA with daily valuations that made its first distribution on July 15, 2003, 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. For subsequent years, under the required minimum distribution method, it would be reasonable 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.”

Revenue Ruling 2002-62

The key issue here is the interpretation of a single word “reasonable”. Further, as of mid-2004, there has been no additional guidance to help us in or interpretation. Thus, this author is going suggest an opinion:

- Safest interpretation --- always use the month-end valuation immediately preceding the first SEPP distribution from the IRA account(s).
- Reasonable interpretation --- use a month-end valuation that is no earlier than 12/31 of the immediately previous year and no later than the date of the first SEPP distribution.

¹³⁷

Back in the old days (pre 1/1/03) we had “determined in a not unreasonable manner” with respect to interest rate selection. That got fixed with a definitive interest rate cap. Now we get “reasonable” account balance determination dates! As usual, clear as mud.

- Risky interpretation --- any valuation date outside the boundaries suggested above or mixing valuation dates when there are multiple accounts involved. In short, we would not recommend venturing into this area unless there were some overriding reasons to do so. Further, should you believe that you do have some overriding reasons or logic for doing so, I would recommend getting an external professional opinion on the subject.

STUB PERIODS

What's a "stub" period? Any period of time that is less than one calendar year.

Suppose John was employed through May, 2000 and would like to start SEPPs of \$60,000 per year in June, 2000 but he does not need nor want the full \$60,000 in 2000 because he had earned income from his old employer for the first five months of the year. Must John wait until 2001 to start his SEPP program? Absolutely not. Instead, John can define his SEPP program in a variety of ways:

- Define an annual SEPP program thus taking the full \$60,000¹³⁸ in 2000.
- Define a quarterly SEPP program thus taking either \$30,000 (for the 3rd & 4th quarters) or \$45,000 (for the 2nd, 3rd & 4th quarters).
- Define a monthly SEPP program thus distributing \$35,000 representing the months of June through December.

All of the above are permissible but only apply to the first year. Commencing in 2001, John must take the full \$60,000.

DISBURSEMENT FREQUENCIES & LOCATIONS

We can define the account universe (implying two or more physical accounts) from which the cash distributions will be made in order to satisfy the SEPP program. Let's assume two accounts for the moment, but it could just as easily be ten accounts. When you decide to make a SEPP disbursement, that disbursement can come from any one or more than one account that was originally defined as a member of the account universe. As an example, if the universe is comprised of two accounts and you wish to make a withdrawal of \$10,000, you may withdraw the \$10,000 all from account #1, \$10,000 all from account #2, \$2,500 from account #1 and \$7,500 from account #2, or any other permutation of dollars between the accounts that suit your needs.

IRC §72(t)(2)(A)(iv) says in part: "(not less frequently than annually)". This creates a

¹³⁸ This theoretically provides John with an extra \$25,000 during 2000 presumably to cover the purchase of the 35 foot sailboat John has always wanted.

one-sided test of once a year. Further, there is no definitive guidance¹³⁹ suggesting any tests on the other side. Accordingly, multiple disbursements are just fine, be they equal or unequal in time or amount. What is critical is that the sum of the distributions made within a calendar year do, in fact, add up to the correct annual amount¹⁴⁰. As a result, a word of caution is appropriate here. Events always seem to get a little hectic around year-ends, sometimes a December 29th transaction does not get processed until January 2nd or vice-versa. If this happens to be your final or first SEPP transaction of the year (or next year) and it is inadvertently mis-processed into the wrong year --- guess what --- your responsible. At a minimum, this situation is going to take some time, persuasion and corrected documents to fix. At a maximum, it is going to look like a program modification. Thus the words of caution; simply avoid the period December 20th through January 10th of the year & transact your business using any one of the other 345 days of the year.

DE MINIMUS ISSUES

“De minimus” equals small or insignificant on either a relative or absolute scale. What is diminimus to the Internal Revenue Service? One dollar. The IRS permits rounding or truncation of pennies on a tax return, but you do not get to round to the nearest \$10 or \$100. This concept comes into play in two circumstances; calculations and cash transactions.

- Calculation --- John, aged 52 with \$1,000,000 in his IRA chooses the minimum method. The calculation is $\$1,000,000 / 32.3$, which equals exactly \$30,959.75. Therefore, both \$30,959 and \$30,960 are equally acceptable representing penny dropping and rounding respectively. \$30,958 and \$30,961 are not acceptable.
- Cash Transactions --- John needs to withdraw \$30,960 and does so by instructing his IRA trustee to distribute exactly \$2,579.95 every month through automatic transfer between his IRA and his checking account. This results in \$30,959.40 in annual distributions; \$0.35 different than the calculation. This difference will be considered diminimus. If John were to err and instruct his trustee to transfer \$2,579.65 every month; thus totaling \$30,955.80 it would create a difference of \$3.95; an amount that would not be considered diminimus.

Any non-diminimus difference has the potential to be treated as a modification resulting in the imposition of the 10% surtax. In this author’s opinion, if John missed by \$3 or even \$10, the IRS would most likely not call it a modification. However, why take the chance particularly when there is nothing but down-side risk. Calculate, recalculate, and stick to the correct amounts within one dollar.

¹³⁹ Actually, this is not entirely true. There are several dozen PLRs all granting the taxpayer the ability to vary the frequency of the distributions made on an intra-year basis. However, invariably, the essence of the PLR was focused elsewhere than on distribution frequency.

¹⁴⁰ IRC §408(d)(2)(B) says: “all distributions during any taxable year shall be treated as one distribution.” As a result, intra-year distribution locations and frequency are entirely at the discretion of the taxpayer.

COST OF LIVING ADJUSTMENTS

The required minimum distribution method has a built-in cost-of-living adjustment, (COLA) of sorts. Each year, the RMD method requires using an updated account balance (hopefully higher than last year's) and using your new age (hopefully only one year older) which in turn creates a smaller divisor from one of the three life expectancy tables you chose to use. This, but for decreased account balances from year-to-year, will automatically result in an increased distribution in all subsequent years. The precise differences change with age, but the single life table will automatically produce a 2½% to 3½% increase annually as one progresses from their 40's through their 60's.

Conversely, the amortization and annuitization methods are one-time, one amount determinations. They do not have built-in COLA features. Pre-1/1/03, COLAed SEPP plans were common. Through a variety of private letter rulings¹⁴¹, the IRS had determined that adding a cost-of-living increase to the fixed amounts determined under the amortization and annuitization methods did represent "substantially equal".

COLAs were both fixed or relative. Fixed COLAs were represented as a percentage increase; e.g. 2%, 3% or 4% per year¹⁴². Relative adjustments required the comparative use of some acceptable indexing mechanism; e.g. the 12/99 consumer price index - national urban¹⁴³ divided by the 12/98 consumer price index - national urban. Such a comparison might result in a number like 1.0245 one year and 1.0337 the next. Thus, if your starting or index year distribution was exactly \$100,000.00; then year two would be \$102,450.00 and year three would be \$105,902.

However, with the advent of Revenue Ruling 2002-62 we are left in a quandary. The Ruling is replete with the phrases: "fixed", "compute once", etc. suggesting that COLAed SEPP plans are no longer permissible. As a result, we are all waiting for some one to expend the effort to submit a private letter ruling request to get COLA plans re-approved. Until such time, launching a COLAed SEPP plan without an outside professional opinion is not recommended.

ANNUAL RECALCULATION OF THE AMORTIZATION & ANNUITIZATION METHODS

This subject received a lot of attention in the late 1990's resulting in more than ½ dozen private letter rulings approving various methodologies for annual recalculation. Finally, in the summer

¹⁴¹ See PLRs 90-47043, 95-36031, 97-26035 and 98-16028.

¹⁴² 2%, 3% and 4% appear to be relatively safe as they have been accepted on multiple occasions. Anything beyond 4% should be considered risky and would warrant a private letter ruling.

¹⁴³ Whenever you might see the CPI broadcast in the general or financial news, they are invariably referring to the "Consumer Price Index - National Urban" statistic as published by the Bureau of National Affairs.

of 2000, the IRS issued an information letter¹⁴⁴. In part, this letter said:

“If payments are recalculated each year using the [amortization or annuitization] method, then payments would be recalculated in the same manner, using the account balance as of the same day each year, the applicable life expectancy (or life expectancies), and the same interest rate “standard” in effect for the same period of the year, which must provide an interest rate that does not exceed a reasonable interest rate on the date payments commence.”

IRS Information Letter, circa 2000

An Information Letter, as defined in Revenue Ruling 2000-4, “calls attention to a well established interpretation or principal of tax law...without applying it to a specific set of facts...An information letter is advisory only and has no binding effect on the Service¹⁴⁵.” As a result, we can rely upon an Information Letter from a theory perspective only and must carefully apply that theory to each individual taxpayer’s unique fact set.

However, in the Fall of 2002, the Service issued Revenue Ruling 2002-62¹⁴⁶ which says in part:

“(b) The fixed amortization method. The annual payment[s]...are determined once for the first distribution year and the annual payment is the same amount in each succeeding year.”

Revenue Ruling 2002-62, Section 2, .01 (b)

The language above is similarly repeated for the annuitization method. In short, Revenue Ruling 2002-62 uses the term “fixed” numerous times such that one could only come to the

¹⁴⁴ The following is an excerpt from an Information Letter received by the author from the IRS; more specifically, the Manager of Employee Plans Actuarial Group II, Tax Exempt & Government Entities Division of the Assistant General Counsel’s Office.

¹⁴⁵ As usual, the Service gets a little carried away (or cautious) with their language here. An Information Letter is binding and it is precedent setting; but only from a theory perspective. It does therefore leave open the question of did a taxpayer properly interpret and apply the theory correctly to his or her own specific facts & circumstances.

¹⁴⁶ In this case Revenue Ruling 2002-62 was issued subsequent to the Information Letter & should further be considered a higher authority than an Information Letter. Therefore, the revenue ruling “trumps” the information letter to the extent applicable.

conclusion that the ruling specifically intended to take away the “annual recalculation” concept. Or did it? Several petitioners have pointed out, via private letter ruling requests, two related principles:

- (1) Revenue Ruling 2002-62 was written in a “safe harbor” manner, e.g. follow all the detailed rules in the ruling and one’s distribution plan will be automatically considered safe or approved, irrespective of the actual mathematical result. The converse is that distribution plans that do not follow all of the rules are not automatically disqualified, rather they are simply in “no man’s land” and are neither approved or disapproved.
- (2) The required minimum distribution method does require annual recalculation saying in part, “annual payments are redetermined for each year.” Additionally, the required minimum distribution method is the same, or is at least calculated the in the same manner, as the amortization method simply assuming an interest rate of zero.

These two arguments formed the basis for several private letter ruling requests asking the Service to formally re-institute annual recalculation for the amortization and annuitization methods. Fortunately, the Service concurred. In the approved private letter ruling¹⁴⁷, the operative language was:

Taxpayer A proposes to determine the annual payment...using the fixed amortization method as described in Revenue Ruling 2002-62, except that rather than making a fixed annual payment, Taxpayer A proposes to recalculate the amount of the annual payment...For subsequent years, Taxpayer A will recalculate the annual distribution for each succeeding year based on the account balance of the IRA as of December 31st of the prior year, determine his life expectancy as of his age in each subsequent year using the single life table... and 120 percent of the federal mid-term rate as of December 31st of the prior year.

PLR 2004-32021

So how do we reconcile all of the “fixed” language found in Revenue Ruling 2002-62 versus the approved PLR language above? Fortunately, we don’t have to. In the Fall of 2002, the Service issued FAQs Regarding Revenue Ruling 2002-62. This document containing seventeen different questions and Service answers to help taxpayers interpret the provisions of Revenue Ruling 2002-62. Of particular note is Q&A 17:

“(17) Are the [computational] methods contained in Rev. Rule 2002-62 the only acceptable methods of meeting section 72(t)(2)(A)(iv) of the Code?”

¹⁴⁷ This language is a direct transcription of a private letter ruling issued in June, 2004. Also see PLRs 2004-32023 and 2004-32024.

No. Another method may be used in a private letter ruling request, but, of course, it would be subject to individual analysis.”

This effectively became an open invitation to taxpayers for the submission of new methods not currently found in Revenue Ruling 2002-62. Although the operative language in the recently approved private letter ruling does not explicitly say so, this PLR effectively create a new method #4, outside the boundaries of the Ruling, making annual recalculation with the amortization¹⁴⁸ concept an approved method¹⁴⁹.

So, now that annual recalculation is back on the approved list, why would we do it and how would we do it? Let’s tackle the why first by focusing a little more closely on how the amortization formula works. The amortization formula uses three variables: principal amount, life expectancy and interest rate; however, not all three variable are equal in manner in which they effect annual distribution outcomes:

- (1) As the principal amount increases (or decreases), the annual distribution amount changes in an linear fashion; e.g. if the principal amount goes up by 15%, the annual distribution amount also goes up by exactly 15%.
- (2) As a taxpayer ages by one year, his or her life expectancy drops, usually by .9 years, resulting in a 1.5% to 2.5% increase in the annual distribution amount.
- (3) As interest rates change so does the distribution amount, but not linearly. A 25% change in the interest rate; e.g. from 4% to 5% only results in a 10.8% increase in the distribution amount; approximately a 2.5:1 relationship.

However, put all the changes together: principal up 15%, one year older and interest rate up 25% and the resultant annual distribution goes up by 30%; just a little more than the additive effect of the individual factors would suggest. Bottom line, most to all of the action is in the change in the principal balance and the effect of aging and interest rate change are minor in comparison. With

¹⁴⁸ This private letter ruling request focused on the annual recalculation and the amortization method skipping any reference to the annuitization method; therefore, in a strict sense we can only say that annual recalculation is now (re) approved for amortization computations, not annuitization computations. Nonetheless, we don’t care. As previously discussed, the annuitization method always produces a lower annual distribution amount than the amortization method, therefore we would always select the amortization method for individual use, with or without annual recalculation, and use other techniques to reduce the annual distribution amount if so desired.

¹⁴⁹ As an intellectual aside, IRC §72(t)(4); that’s the code section that invokes the 10% surtax retroactively, says “the series of payments...are subsequently modified” really should apply. The annual recalculation process does cause the payments to be modified; however, the Service has graciously interpreted this to mean that as long as the plan remains unmodified, §72(t)(4) does not apply even though the payments themselves are modified. As the old saying goes, as long as the interpretation is in our favor, we do not look a gift horse in the mouth.

this in mind, how might a taxpayer successfully and effectively implement annual recalculation?

With the fixed amortization method, the outcomes are known; e.g. a 55 year old with \$1,000,000 using a 4% interest rate will distribute \$58,240 per year for the next five years. The only unknown in this situation is the ending IRA balance five years in the future which will be predominately determined by investment experience less the aggregate of the annual distributions of \$291,200.

With annual recalculation, the future annual distributions become variable and unknown. Another word for “unknown” is risk! So, at least initially, we should consider annual recalculation as “riskier” than the fixed computation. In this regard, there are several types of risk both downside and upside:

- (1) Taxpayer living expenses tend to mixed; e.g. some are fixed and some are variable. Mortgages, the utility bills, food look more like fixed expenses. Vacations, cars, medical expenses tend to look like variables expenses. What if the a future period annually recalculated distribution comes up with a number that is less than the taxpayer’s annual fixed expenses? Not a good place to be unless other resources are available to take up the slack.
- (2) On the upside, what if a future period annually recalculated distribution comes up with a materially larger number than needed potentially causing a jump upward in federal and state tax brackets causing too much tax to paid too early? Not exactly the worst situation in the world, but one to be avoided if possible.

A way to mitigate these risks is to adopt multiple SEPP plans. As usual, assume John, aged 55 has a \$1,000,000 IRA and has thoroughly analyzed his family living expenses and has categorized them as \$40,000 fixed and \$20,000 variable. Lastly, the current applicable interest rate is 5%. John has three fundamental choices:

- (1) Adopt one fixed amortization plan distributing \$65,400 per year. Better yet, John should split his IRA into two IRAs of \$920,000 and \$80,000 distributing \$60,200 from IRA #1 and holding IRA #2 on side for unplanned emergencies.
- (2) Adopt one annually recalculated amortization plan distributing \$65,400 in year one. By year three:
 - (A) John’s IRA is worth \$1,600,000, interest rates are now at 7% and John is 58 resulting in a distribution of \$133,480.
 - (B) John’s IRA is worth \$500,000, interest rates are now at 4% and John is still 58 resulting in a distribution of \$30,600; well below his fixed annual living expenses.

Both of the outcomes above are undesirable. In 2(A) John is forced to distribute funds he does not need and will likely jump a tax bracket or two paying more marginally

higher federal and state taxes than he should. In 2(B), John, unless he has other non-IRA related financial resources to fill in the cash flow shortfall, is bankrupt to the extent that he will be forced into some untimely and likely unpleasant life style changes.

- (3) Adopt two amortization plans; plan one is fixed using IRA #1 with a balance of \$620,000 yielding \$40,600 per year in distributions; very closely matched to John's annual fixed living expenses; plan two is annually recalculated using IRA #2 with a balance of \$380,000 yielding a distribution of \$24,900, at least for the first year. Let's re-apply the same year three outcomes:
 - (A) John's IRAs are now worth \$1,600,000 (\$992,000 in IRA #1 and \$608,000 in IRA #2). Interest rates are at 7% and John is now 58. Because plan #1 was fixed, \$40,600 is still distributed. Plan #2 is variable and therefore \$50,700 distributed for a total of \$91,300; still probably more than John wanted to distribute, but still a fairly nice "in between" number; higher than the \$65,400 in (1) above, but whole lot less than the \$133,480 in (2) above.
 - (B) John's IRAs are now worth \$500,000 (\$310,000 in IRA #1 and \$190,000 in IRA #2). Similarly, interest rates are at 7% and John is now 58. Again, \$40,600 is distributed from plan #1. Plan #2 is recalculated and the distribution is \$15,850 for a total of \$56,450; an aggregate distribution that is smaller than John would like, but certainly a livable number that does not force a drastic lifestyle change at exactly the wrong time.

The above are needless-to-say, simplistic examples of potential outcomes and every taxpayer's circumstances are going to be different. Accordingly, taxpayer's should think and model their way through this issue very carefully. Several additional points are worth consideration:

- (1) Bob, John's brother says to himself: "I would never, ever invest so imprudently as to let my IRA balance fall by 50% over three years!" We know lots of Bob's and we get phone calls and emails from them weekly. Further, remember that Bob or John's IRA is getting hit twice each year; roughly a \$50,000 annual cash distribution as well as the depreciation in the marketable securities in the account. As a result, it only takes a 35% decrease in value to actually halve the aggregate value of the account; approximately 10% per year compounded.
- (2) John retains the ability to perform a one time method switch to the RMD method¹⁵⁰. As a result, let's compare the upside outcomes of scenarios (2) and (3). In (2), John was forced to distribute \$133,480; no other options are available. In (3), John has two options: (a) distribute \$91,300; (b) switch plan #1 from the fixed amortization method to the RMD method resulting in a distribution of \$36,740 plus the \$50,700 from plan #2 totaling \$87,440; not a whole lot less than the \$91,300; but still materially less than

¹⁵⁰

The one-time change to the RMD method is only permitted with respect to the fixed amortization and annuitization methods, not the annually recalculated methods.

the \$133,480 distribution required in (2).

In summary, bifurcating¹⁵¹ the IRAs in advance represents a valuable planning tool that can be used to retain distribution flexibility for future years. The retention of the flexibility becomes insurance against the risks associated with adopting annually recalculated plans while retaining what are hopefully the “upside” benefits.

Now that we know how to effectively plan the use of an annually recalculated plan, how do we tactically implement correctly? Fortunately, the operative language in the PLRs is essentially the same as found in the Information Letter of 2000. In this regard:

- (1) All three variables must be updated¹⁵² simultaneously when recalculating.
- (2) All three variables must be updated as of the same day each year. Theoretically, any day of the year is an acceptable day; however, month-ends, quarter-ends and year-ends are recommended as this may be the only time that external evidence is available to “prove up” an IRA balance.
- (3) No methodology changes are permitted; simply a substitution of new values and the resultant computation.

So how might we implement this? Let’s use John again with a \$1,000,000 IRA, aged 55 and an interest rate assumption of 5%. Lastly, the date is July 1, 2004. The mathematics of the amortization formula dictate an initial annual distribution of \$65,440¹⁵³. Now, John has some options:

- (1) Distribute the full \$65,440 sometime between 7/1/04 and 12/31/04; or, chose to treat 2004 as a “stub-year” distributing a prorata amount for 2004 of \$32,720 representing ½ of the year.
- (2) John’s first recalculation date need not be one year in the future and there is good reason for it not to be. John might decide to recalculate as of 12/31/04. Assume his 12/31/04 IRA balance is \$1,100,000, the interest rate rises to 5.25% and he now 56 years old. Again the mathematics of the amortization formula dictate an annual distribution for 2005 of \$75,026¹⁵⁴. John has all of 2005 in which do distribute this

¹⁵¹ Actually, the author recommends trifurating (if there is such a word) one’s IRA into three IRAs; IRA #1 used to launch a fixed SEPP plan, IRA #2 used to launch an annually recalculated plan, and IRA #3 held on the side for unplanned emergencies.

¹⁵² This is contrary to some of the rulings issued in the 1990's where taxpayers did receive some favorable rulings permitting the updating of just two of the three variables; most often updating the IRA balance and age but holding the interest rate constant.

¹⁵³ Using Lotus 123, this would be @pmt(1000000,.05,29.6).

¹⁵⁴ Using Lotus 123, this would be @pmt(1100000,.0525,28.7).

amount in a single or the sum of multiple distributions. Going forward, John absolutely must recalculate as of December 31st for all future years in the plan.

John could also pick a different recalculation date; e.g. 6/30/05. However, there are advantages and disadvantages in doing so:

- (A) Delaying the recalculation date a full year (as opposed to six months) provides more time for the corpus of the IRA to grow; thus, all else being equal, delaying would more often than not provide a higher annual distribution.
- (B) Distributions in advance of the computation are not permitted; they are also a bit illogical. Therefore, John can not distribute from the account during the period 1/1/05 to 6/30/05 but must instead wait, recalculate, then distribute.
- (C) Related to (B) above, fiscal year computations, at one time allowed, are no longer. As an example, it would be nice to define a SEPP year as 7/1/04 to 6/30/05 with a required distribution of \$65,440 during that time period. This makes imminent logical sense however, it grants a flexibility that can be materially abused by taxpayers; e.g. John could then manage his distributions across year-end boundaries, as he is a calendar year taxpayer, to artificially inflate/deflate recognized income between adjacent tax years. Thus, although a good idea, it is not permitted.

Finally, annual recalculation can get complex, particularly when multiple accounts and lives are being updated. To that end, this author strongly suggests that anyone planning on a SEPP program including annual recalculation should write themselves a contract. Amazingly, we all tend to forget the details over time¹⁵⁵. In this situation, success is in the details. Here is some model language that can serve as a starting point:

YOUR NAME
LETTER OF SELF-DETERMINATION FOR
SUBSTANTIALLY EQUAL PERIODIC PAYMENTS
PURSUANT TO IRC §72(t)(2)(A)(iv)

I, [your name], have elected to commence substantially equal periodic payments pursuant to IRC §72(t)(2)(A)(iv). I am including the following list of IRA accounts: [list of accounts, locations, account numbers and balances] totaling [the aggregate balance] as of [the most recent month-end preceding the commencement of the SEPPs or other valuation date]. I am electing to use the amortization distribution method as described in Revenue Ruling 2002-62. My birth date is [your birth date]; therefore my highest attained age in 20XX [is / will be] [NN]. I have further

¹⁵⁵ Do you remember what you bought your significant other as a Christmas gift for 2002?

elected to use the [single life table, uniform life table, joint & survivor table]. Lastly, I have elected to use an interest assumption of Q.QQQ%; this percentage equal to the higher of 120% of the mid-term applicable federal rate for the months of [list the months] immediately preceding my first distribution month of [insert month & year]. This in turn results in an annual distribution for 20XX of \$XX,XXX.XX. I [am / am not] electing to treat 20XX as a stub year resulting in 20XX distributions of \$XX,XXX.XX.

I intend to continue these substantially equal periodic payments commencing in [insert commencement month and year] and running uninterrupted to no less than [insert the month and year or actual date upon which you will attain the age of 59 ½ or the expiration 5 years] so as to avoid the reapplication of the 10% early withdrawal surtax as required under IRC §72(t)(1) & §72(t)(4)(A).

Lastly, I am adopting the amortization method, as described above, on an annually recalculated basis. My annual recalculation date is [insert month & day] of each year commencing in 20XX and running through 20YY. On each of these dates, I will recalculate my annual distribution using updated IRA balance(s) as of that date, an updated interest rate assumption equal to a percentage being equal to the higher of 120% of the mid-term applicable federal rate for the two months immediately preceding, and an updated life expectancy derived in the same manner as above using the [describe the life expectancy tables used].

The above should be signed, dated and copied twice. The original should go to your place of safekeeping; e.g. safety deposit box; copy #1 should go to your annual tax files; copy #2 should be sent as an attachment to whatever forms your trustee requires be completed in order to actually perform the distributions. The intent here is provide readers with the basics which should be included in a contract. Readers are free to modify and enhance the above templates to fit unique situations.

EVIDENCE

Those taxpayers that faithfully fill-out and mail in their warranty registration cards can skip this section; you all know what to save and where to put it. For the rest of us mortals, evidence is an important issue.

Every year, the IRS gets one piece of paper (albeit electronically) called a 1099R. The trustee of your deferred account is required by law to issue this document to you and the IRS every year identifying the distribution amounts you have taken in the preceding year. That's all the IRS gets. Further, to the best of our knowledge, there is absolutely no evidence (no pun intended) that taxpayers on SEPP plans are more or less likely to be audited. Conversely, there is a 100% likelihood that if you are audited and have a SEPP plan in place, that it will be scrutinized. As a result, audits do happen for a variety of reasons and SEPP planners need to be fully prepared if that event occurs. What do you need?

- (1) Start with the "contract" or letter of determination. Complete it, date it, sign it & copy it. This is a summary document and will keep you, the taxpayer, on the straight and

arrow path. However, it is self-created & thus is considered internal evidence. You will need external evidence as well.

- (2) You chose an IRA or multiple IRAs or other deferred accounts. Please show me (this the IRS auditor talking) your December 31st (or other valuation date) account statements which you used to determine you beginning computational balance.
- (3) You chose to commence distributions in April, 2004 using the amortization method and an interest rate of 4%. Please show me the 120% of mid-term applicable federal rates for February and March, 2004.
- (4) You claim that you were 52 when you commenced distributions. Please show me your driver's license or a birth certificate.
- (5) Oh, I see you adopted the amortization method using annual recalculation. Please show me all of the above for every year your SEPP plan has been in operation.
- (6) Just to wrap up this part of the audit, please show me EVERY 1099R you have received since the beginning of your SEPP plan.

The author absolutely guarantees that if you are audited, all six of the above questions will be asked. You, the taxpayer, must be ready to produce and not having it is not an acceptable excuse. Also, please gather and safe keep these materials NOW. Don't wait until the 4th or 7th year and then panic when the audit notice arrives.

Enough said, you now know what to save & where to put it. While your at it, fill out your product warranty cards and mail them in.

DEATH AND DIVORCE

Unfortunately, both death and divorce are part of life. How does the IRS treat these issues if SEPPs are currently in progress? If the taxpayer receiving the SEPP distributions dies¹⁵⁶, before attaining the age of 59 ½ or the passage of five years, then the SEPPs may cease and no penalties or interest are assessed. Further, if the SEPP recipient's spouse dies, the IRS has further ruled¹⁵⁷ that the surviving taxpayer can then recalculate future SEPPs using new methods and life expectancies. Thus, some flexibility is granted; however, the SEPPs must continue in some fashion.

If a taxpayer and his or her spouse divorce, the SEPPs, by default, stay with the taxpayer who was originally receiving them. But, what if the assets within the SEPP universe are split

¹⁵⁶ See IRC §72(t)(2)(A)(ii).

¹⁵⁷ See PLRs 89-19052 and 90-47076.

(let's say 50% and 50%) pursuant to a QDRO?¹⁵⁸ The IRS has ruled on numerous occasions that there are several solutions available as follows:

- For the original IRA owner & recipient of the SEPP withdrawals; he or she may:
 - Continue the existing SEPP distributions as if nothing has happened.
 - Continue the existing SEPP distributions on a proportionate or ratably reduced basis. For example, assume that the original SEPP program called for a \$60,000 per annum distribution & the taxpayer has just transferred 50% of the IRA to his or her ex-spouse. Our taxpayer can continue post-divorce SEPPs at \$30,000 per year.
- For the new IRA owner who has received what is essentially a new IRA from his or her ex-spouse; he or she may:
 - Do nothing at all.
 - Commence a new SEPP program completely independent and unrelated to the SEPP program that was in progress with the ex-spouse.
 - Voluntarily pick-up the remainderman \$30,000 of SEPP distributions per year. In this last case, the history of the prior-year SEPPs would accrue to the new IRA owner; e.g. suppose that \$60,000 per year had already been running for three years; then, the new IRA owner would “so to speak” receive three years of credit towards satisfying the five year rule. However, the new IRA owner's age (independent of the ex-spouse's age) would now govern in applying the 59 ½ test.

Thus, in the case of divorce there is some good news in that the Service has granted several different planning opportunities. However, caution should be exercised here in that the transactions and elections should be carefully structured and documented.

SIMULTANEOUS PROCESSING WITH OTHER EXCEPTIONS

IRC §72(t) has been amended numerous times to point where it now contains twelve different exceptions ranging from the originals --- death and disability --- to a new group of exceptions for new home purchase, excessive medical expense and educational costs. How does the application of IRC §72(t)(2)(A)(iv) interact with the simultaneous application of other exceptions?

- Clearly, if you have two IRAs, A & B, and SEPPs are in progress using IRA A; any and all exceptions can be used on IRA B without fear of conflict. Given that financial

¹⁵⁸ A “QDRO” is a qualified domestic relations order. The actual splitting of the IRA assets between spouses (or other family members) is a non-taxable transaction under IRC §414(p).

emergencies are common, the astute taxpayer will design his or her SEPP program with a minimum of two IRAs, one for SEPPs and one as “dry powder” on the side to handle the unexpected.

- What about simultaneous processing of SEPPs and another exception on the same IRA? The concept of the frozen account universe for SEPPs and the only transaction permitted being the actual SEPP withdrawal would seem to argue against the processing of another exception transaction. On the other hand, there is no statutory provision prohibiting such an action. Therefore, why shouldn't a taxpayer be able to avail himself of such a transaction?

As usual, the answer is unclear. Further, the IRS has never ruled on this particular issue; leaving us in virgin territory. As a result, this author would suggest the path of conservatism. Either don't attempt such a transaction or pursue a private letter ruling on the subject.

TAX PLANNING ISSUES FOR THE WEALTHY

Are you wealthy? You might not think so; however, if you are reading this text, you have a high likelihood of fitting Congress's definition of wealth. By definition, Congress tells us that the wealthy commence at \$70,350 of taxable income (for single individuals) and \$117,250 of taxable income (for married couples) for tax year 2004. This is taxable income, not adjusted gross income, so we can probably set gross income limits of \$80,000 and \$130,000 fairly easily. This then represents the practical floor, above which income will be taxed at 28% or more.

Conventional wisdom says that IRAs, 401k's and the like are retirement vehicles that are typically off-limits until age 60 or so. Making a withdrawal to buy the Ferrari (or two trips around the world) is nothing but robbing from your own future. These are generalities that are most often true, but not always true. Let's return to John, age 52 who is still working and plans on continuing to work at a salary of \$100,000 per year. Further, John is married with two teenagers, two cars, a mortgage and a front lawn to mow. As a result, John's taxable income, due to itemized deductions and four exemptions, is \$70,000 per year; about mid-range in the 25% tax bracket. Further, John already has \$2,000,000 in deferred assets. Additionally, John can reasonably expect his \$2 million to double in the next eight years and grow five-fold or more by the time he is seventy. Assuming \$10 million at age 70, John's minimum required distribution will be \$365,000 per year and it will only go up from there. In short, John will instantly be catapulted into the 35% tax bracket, or whatever else is the maximum tax bracket by then.

What should John do? Although it is a bit counter-intuitive, John should start SEPPs now, most likely in the range of \$25,000 to \$50,000 per year. In no way is it being suggested that John spend these distributions! Instead, we are suggesting that John convert \$50,000 per year now from a deferred asset account (which will always be taxed as ordinary income when withdrawn) and pay 25% federal tax investing the net after-tax amount in a long-term conservative and capital gains oriented investment strategy. Why? During the intervening years, be it 8 or 18, John will pay 25% tax

on withdrawals from his IRA; conversely, if he waits¹⁵⁹ those same dollars will be taxed at 35% when withdrawn. Further, the early withdrawals can be re-invested in capital gain oriented investments with a maximum tax rate of 15%.

In short this is an exercise in tax bracket and tax method management. Most taxpayers, to their unwelcome surprise, are going to learn that their marginal tax bracket will not go down in retirement; for most their marginal tax bracket will, at best, stay the same and will likely rise. In these circumstances, several axioms come to mind:

- Always attempt, in this case through planned SEPP withdrawals, to recognize additional income in lower marginal tax bracket years.
- Always attempt to re-invest excess income in tax sheltered, tax free, dividend producing or capital gains taxed instruments.

The picture painted above is overly simplistic and most likely not reflective of your personal financial circumstance. However, were it to be true, notice that John does not have the luxury of waiting eight years to see the outcome. John needs to be looking at these issues right now, using some personal financial modeling and intuition about future events and outcomes. Everyone can do a quick computation of the big dollar issues in an hour or two using a spreadsheet or purchased financial planning software.

IMPROPER TRANSACTIONS

Usually, IRS regulations & rulings are lengthy (in both time to issue as well as pages), technically precise and confusing in the sense that one can get lost in the trees and not see the forest. Revenue Ruling 2002-62 is the exception to the general rule. From inception to issuance only took 4 - 6 months¹⁶⁰, is a model of brevity, but also contains some extremely confusing language.

For the first time, Revenue Ruling 2002-62 provides some guidance on deferred account management and what the Service will consider to be a modification remembering that a “modification” invokes IRC §72(t)(4) which in turn imposes the 10% surtax plus interest from the commencement of the substantially equal periodic payment stream. Thus, all taxpayers are desirous of avoiding the following:

¹⁵⁹ The IRS has borrowed some one’s “auto repair” ad campaign in 90's that said: “You can pay me now or you can pay me a lot more later.”

¹⁶⁰ The equivalent of Warp 12 on the Starship Enterprise.

(e) Changes to account balance. Under all three methods, substantially equal periodic payments are calculated with respect to an account balance as of the first valuation date selected in paragraph (d) above. Thus, a modification to the series of payments will occur if, after such date, there is (i) any addition to the account balance other than gains or losses, (ii) any nontaxable transfer of a portion of the account balance to another retirement plan, or (iii) a rollover by the taxpayer of the amount received resulting in such amount not being taxable.

Revenue Ruling 2002-62, .02(e)

At first glance, the above seems to be pretty clear. Upon second glance it gets confusing. Upon third glance, it becomes downright contradictory. Upon fourth glance, no one is absolutely sure what it says. Further, there have been no subsequent rulings or other explanations to provide additional guidance on what this really means. As a result, we are in new territory and have to make some educated guesses as to the Service's intent. However, there are two or three principles that can guide us in the following analysis:

- (1) IRC §408(d)(3)(A) is commonly called the “rollover” rule. It statutorily grants every taxpayer the ability to distribute money from an IRA to themselves (thus initially creating a taxable event) and then subsequently redepositing those monies into an IRA within 60 days (thus erasing the taxable event). Further, taxpayers can elect to perform one rollover per year per account. Thus, using the rollover rule, a taxpayer might withdraw \$20,000 from their IRA to payoff a car loan; sell the car within 60 days and use the sale proceeds to put the \$20,000 back in the IRA.
- (2) Related to (1) above but technically dissimilar are “trustee-to-trustee” transfers (“TTTT”)¹⁶¹. TTTT's are not qualified under IRC §408(d)(3)(A) because technically they are not rollovers; instead they are, from inception, tax exempt transfers from trustee A to trustee B without intervention by the taxpayer. In this case, the taxpayer never has constructive receipt of the money (unlike (1) above) but would use this technique to move an IRA from an old full-service brokerage to a new discount brokerage.
- (3) The IRS has explicitly identified three circumstances which they consider to be “modifications”. However, some of the language in Revenue Ruling 2002-62 seems to run in conflict with (1) and (2) above; or does it? This author would suggest a little creative language expansion to clarify the situation. When ruling reads: “*a modification to the series of payments will occur if,*” should be interpreted to read as: “*a modification to the series of payments will occur if the taxability of the annual payment stream is altered as a result of:*”.

¹⁶¹ See Revenue Ruling 78-406 (1978-2 C.B. 157).

With these concepts in mind, let's take a more detailed look at each of the three "modifications" identified by the IRS:

ACCOUNT REPLENISHMENT

(i) any addition to the account balance other than gains or losses,

During the Summer & Fall of 2002, the Assistant General Counsel's office was inundated with private letter ruling requests¹⁶² all implicitly suggesting mechanisms for individual taxpayers to either terminate or materially modify their SEPP distributions. One of the tactics frequently suggested was the use of "account replenishment". Assume John commenced SEPPs some years previous with an opening IRA balance of \$1,000,000. However, John, split his IRA into two IRAs, A & B with \$700,000 and \$300,000 respectively. He commenced his SEPP distributions on IRA A only. Several years later, IRA A had materially diminished in value, let's assume to \$200,000, thus presenting a circumstance where John faced certain account exhaustion before his 59 ½ birthday. John, through a PLR request suggested a corrective action by "replenishing" IRA A with the contents of IRA B; implicitly recasting the SEPP program from inception with a starting balance of \$1,000,000. This strategy would have solved John's problem of insufficient assets; however, it clearly would have applied to only those taxpayers who had bifurcated their IRA assets before commencing SEPP distributions. Effectively, this portion of the ruling disallows this strategy with a direct NO. Further, permissibility of such a transaction would likely change the timing and/or amount of distribution taxability. Lastly, other portions of Revenue Ruling 2002-62 give taxpayers several other "outs" to either decrease or terminate their distributions thus making this technique rather moot.

TRANSFERS TO RETIREMENT PLANS

(ii) any nontaxable transfer of a portion of the account balance to another retirement plan,

Let's remember that for purposes of IRC §72(t), we need to look at IRC §4974(c) for a definition of a "retirement plan". In this case we find all the usual suspects: §401(a) plans; §403(b) plans and §401(k) plans. In addition, §408(a)'s are included; more commonly known as IRAs. Therefore a literal read of the above says an IRA-to-IRA rollover or a TTTT is no longer permitted! Not true. Congress has traditionally taken a pretty dim view whenever the IRS has attempted to overrule them as would seem to be the case here. However, the IRS is not attempting to overrule Congress; if anything, the IRS is simply guilty of some sloppy language. What the IRS was trying to say was a taxpayer can not use a rollover or TTTT to alter the taxability of the substantially equal periodic payment stream.

As an example, some taxpayers originally commenced SEPP distributions from a rollover IRA created from a prior employer qualified plan distribution. Seeing their assets evaporate, some of these taxpayers re-entered the work force and were re-employed by another employer who also had a qualified plan that accepted rollovers. Some taxpayers wanted to "roll-in" the contents of

¹⁶² The AGC's office received several dozens of requests which resulted in all related PLR requests being temporarily suspended. Subsequently an internal study group was formed whose end product was Revenue Ruling 2002-62. As a result, most, if not all, PLR requests were returned to the submitting taxpayers with a refund of filing fees.

their conduit IRA into their new employer's plan. Needless-to-say, the SEPP distributions would have to stop as the new employer could not continue the periodic distributions as it would represent a violation of the "separation of service" rule. In short, it was an ill-fated strategy of using a new retirement plan as a blocking mechanism to cease SEPP distributions prematurely. Again the Service has sensibly said NO; they just did not say it very well.

ROLLOVERS

(iii) a rollover by the taxpayer of the amount received resulting in such amount not being taxable.

Well of course, the purpose of doing a rollover is so that it is not taxable. In this case, however, the IRS is talking about attempted rollovers of the distribution dollars as opposed to rolling over all or portion of the corpus of an IRA. Rollovers of required minimum distributions have long been disallowed pursuant to IRC §401(a)(9) & related regulations; otherwise everyone's grandmother would make their RMDs and then immediately roll them over into an IRA thus perpetuating an IRA account forever. The same applies here.

One of the other asset preservation strategies suggested was for John to run the SEPP distribution dollars in a circle. John was taking one annual distribution of \$60,000 per year from his original IRA of \$700,000; now down to \$200,000. Further, John realized the impracticability of his situation and re-entered the employed workforce; thus, John no longer wanted or needed the \$60,000 per year distribution. John thought why not just rollover the \$60,000 distribution into the same or other IRA thus erasing the taxable event and preserving his IRA assets. Again, the Service has said NO.

SUMMARY

The key to interpretation of all three situations is an examination of how the taxability of the SEPP distributions is altered (not good) or remains unaltered (generally okay). The transactions in each case are permissible, as granted by statute or earlier proclamation by the IRS. No one was attempting to take away any taxpayer rights here; simply the IRS was putting everyone on notice to not attempt to alter the taxability of the SEPP distribution stream through inappropriate use of any of these techniques.

PLANNING FOR FLEXIBILITY

If readers are going to read just one topic in Chapter 6 — THIS IS IT! If I am going have one SEPP plan, is two better? YES. I have two SEPP plans, is three better? MAYBE. I have three SEPP plans, is four better? DOUBTFUL. Three years from now some significant percentage of taxpayers who initiated SEPP plans three years previous are going to say: "My SEPP plan and my personal financial plan / circumstances are out-of-synch. What do I do now?" The answer is one needs to plan for flexibility before executing!

The greatest advantage of SEPP plans is that they exist as a method for early retirees to avoid the 10% surtax. Their greatest and overriding disadvantage is that they are rule bound and fundamentally fixed; once started they may not change. Unfortunately, life in general and one's

financial life in particular tend to be fluid. Sounds like an “oil & water” situation and it is. However, there are several planning techniques that can be used to mitigate the risks associated with SEPP plans.

IRC §72(t)(2)(A)(iv) is always first applied on an account-by-account basis. Therefore, it is perfectly acceptable to have two or more IRA accounts, launching a SEPP plan on IRA #1 and doing nothing with IRA #2. This makes imminently good sense. This author calls it “dry powder on the side”. Everyone, given enough time, experiences unexpected financial needs and emergencies. These needs can be downside, such as an unexpected and uninsured medical emergency; or they can be on the upside such as the desired purchase of a vacation home.

IF YOU HAVE ALL OF YOUR ASSETS TIED UP IN ONE IRA ACCOUNT, YOUR HANDS ARE TIED WITH RESPECT TO YOUR ABILITY TO HANDLE UNEXPECTED FINANCIAL NEEDS.

Let’s take an example. John, aged 50 has \$1,500,000 in his IRA, which is also his only significant financial asset other than his home. Using 5%, John commences SEPP distributions of \$92,400 per year which, in this case, is \$10,000 more per year than John really needs. However, John figured he was better off taking a little extra and saving it in an after tax account to handle minor unplanned issues that might come up. Five years later, John faces a major financial emergency (positive or negative) and needs \$150,000 right away. He has \$50,000 saved up at the bank as the net after-tax savings of his unspent extra distributions from the preceding five years. Where does he get the other \$100,000? In this case, the financial emergency is serious enough that John busts his SEPP plan to gain the additional funds. Instead of taking out \$92,400 in year six, he is forced to take out \$430,000!!! Watch how this math works:

Year six IRA distribution:	\$430,000
Regular income taxes:	<u>(150,000)</u>
Net available for use:	<u>\$280,000</u>
Regular living (\$92,400 net of tax):	\$70,000
The extra \$100,000:	\$100,000
Penalties & interest on prior distributions:	\$66,000
10% surtax on this year’s distribution:	<u>\$43,000</u>
Total uses:	<u>\$279,000</u>

One way to look at it is that John just paid a 60% tax! He withdrew \$430,000 of which he used \$70,000 for normal living needs and used another \$100,000 to meet the extraordinary financial need; everything else went to pay for taxes, interest and penalties totaling \$259,000. The desire to avoid this situation becomes self-evident.

Now let’s look at an alternative strategy that could have handled the same situation. John splits his IRA into two IRAs of \$1,300,000 and \$200,000 before commencing his SEPP plan. He starts SEPPs on IRA #1 only of \$80,000 per year leaving IRA #2 untouched. However, the lowered annual distribution does not leave him any room to save in an after-tax account. As a result, when the

same financial emergency occurs in year six, John has to withdraw enough from IRA #2 in order to meet the need. This withdrawal is “only” \$335,000 which will get taxed at 45%; 35% regular federal income tax plus a 10% early non-qualifying distribution penalty. John’s total tax bill for year six is somewhere in the neighborhood of \$190,000; still a pretty major amount; nonetheless, John could have saved approximately \$70,000 in taxes by one simple step; always, always split your IRAs before starting a SEPP plan or otherwise have non-IRA assets on the side to handle financial emergencies of sufficient size that the SEPP plan will not need to be busted in order to meet the financial need.

On the presumption that your principal retirement asset is your IRA, this makes a pretty good case for having two IRAs. How about having three IRAs and launching SEPP plans on two of them holding IRA #3 in reserve as the “dry powder”? EVEN BETTER. Let’s presume John read this section and split his one big IRA into three smaller ones of \$650,000; \$650,000 and \$200,000. Next, John launches two SEPP plans, one each on IRAs 1 and 2, leaving IRA #3 as the reserve. The annual distribution from SEPP plan #1 is \$40,000 and the annual distribution from SEPP plan #2 is also \$40,000. Further, John has been prudent in his investing such that his IRA balances at the end of year five are: \$600,000, \$750,000 and \$300,000 respectively. Year six arrives and John receives an unexpected annuity inheritance of \$25,000 taxable per year. John’s first thought is how can he modify (without incurring any penalties and interest) his SEPP plans to meet his new financial situation?

- (A) With only one SEPP plan using an IRA now worth \$1,350,000; John can make the one-time switch to the RMD method. At age 56, this becomes an annual distribution of approximately \$47,000 per year. This, plus the inheritance gives John total income of \$72,000 per year (a little short to meet his living needs) or he can just stay the course continuing to distribute \$80,000 as originally designed thus providing \$105,000 in total (a little long in comparison to his living needs).
- (B) With two IRAs and two SEPP plans, John creates a total of four financial solutions:
 - (1) Stay-the-course distributing \$40,000 from IRA #1; \$40,000 from IRA #2 plus the \$25,000 annuity for a total of \$105,000.
 - (2) Convert SEPP plan #1 only to the RMD method resulting in a distribution of \$20,900; leave SEPP plan #2 alone thus distributing \$40,000; plus the annuity of \$25,000, totaling about \$86,000 per year.
 - (3) Convert SEPP plan #2 only to the RMD method resulting in a distribution of \$26,100; leave SEPP plan #1 alone thus distributing \$40,000; plus the annuity of \$25,000, totaling about \$91,000 per year.
 - (4) Convert both SEPP plans to the RMD method yielding \$47,000; plus the annuity of \$25,000; totaling \$72,000.

The key issue here is that conversion from an existing fixed amortization or annuitization plan to the RMD method is a plan-by-plan decision, not a taxpayer-in-total decision. As a result, splitting one IRA with one SEPP plan into two IRAs with two SEPP plans doubles the financial solution set from 2 to 4 with in between stopping points that are often more palatable. Further,

splitting into three IRAs with three SEPP plans again doubles the financial solution set from 4 to 8.

Thus, is it wise to have two IRAs (actually three because one is always on the side for “dry powder”) and two SEPP plans? YES, as it creates 4 financial income solutions as opposed to 2 when the financial landscape changes in the future. Is it wise to have three IRAs and three SEPP plans? MAYBE; the advantage is that the financial solution set increases to 8. Is it wise to have four IRAs and four SEPP plans? DOUBTFUL, at least in this author’s opinion. The solution set does double again to 16, but to what end? Further, the administrative record keeping starts to look rather onerous.

However, in all of the cases discussed above; whether to have one, two or three SEPP plans is a PRE-PLANNED decision! Once commenced, meaning the 1st distribution is made, all of the options vanish. Once John makes that 1st distribution of \$80,000 from the \$1,300,000 IRA; he has forfeited his ability to split that IRA into two IRAs with two plans; he must think this issue through in advance and organize all the required IRAs into the desired positions (number of IRAs and balances in each) before any distributions are made.

Let’s look at a third situation that frequently arises. John has the same \$1,500,000 IRA but only needs \$50,000 per year currently. However, in six years, John’s children will both be attending college with an anticipated cost (at least to John) of \$20,000 per child per year. What should John do?

- (1) Split the IRA into two IRAs of \$820,000 and \$680,000; commence a SEPP plan of IRA #1 only yielding an annual distribution of \$50,500 per year. Do nothing with IRA #2.
- (2) Assume over the course of five years, IRA #2 grows to \$1,000,000 (not unreasonable @ 8% per year).
- (3) At the six year mark, split IRA #2 into two IRAs of \$620,000 and \$380,000; commencing SEPP plan #2 on IRA #2 only yielding \$41,100 per year in distributions. IRA #3 is left untouched as the dry powder.
- (4) Over the next four years IRA #3 grows to approximately \$500,000 when John, Jr. announces his admission into Harvard Law School, but no scholarship. At this point, John is well positioned in several respects:
 - (A) The sum of IRAs 1, 2 & 3 are somewhere in the \$2.2 to \$2.5 million range so he at least has the assets to write big checks to Harvard.
 - (B) John is now 60 so his SEPP plans are almost all done (technically, SEPP plan #2 — the under graduate college funding plan still has one year to go) such that he can disburse the money from IRA #1 or IRA #3 as he sees fit.

What does all of the last four or five pages imply? One, plan, re-plan; and when you think your done, re-plan it again. Two, you don’t have a handle on your regular living expenses? Don’t even contemplate a SEPP plan until you do. You don’t know how to get a handle on your living expenses? Hire a financial planner or CPA; they will be infinitely cheaper than the surtaxes and interest

that is otherwise likely to occur.

SEPP PLANS COMBINING REGULAR & ROTH IRAs

This author's first reaction was no; second reaction was maybe; third reaction was I don't know, I had better go find out. We rephrased the question a bit to ask: "can the balances of a traditional IRA and a ROTH IRA can be logically combined in the design of a SEPP plan?" This question, in turn, poses three separate questions as follows:

- (1) Is the combination of a Traditional IRA and a Roth IRA permissible for IRC §72(t)(2)(A)(iv) purposes?
- (2) Presuming the answer to (1) above is affirmative, what are the ordinary income tax consequences of those distributions?
- (3) Related to (2) above, would any recapture taxes, as imposed by IRC §408A(d)(3)(F)(i) be applicable?

We necessarily need to begin with IRC §72(t) itself. It says, in part: "If any taxpayer receives any amount from a qualified retirement plan (as defined in section 4974(c)), 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." Said another way, if you take a distribution from a qualified retirement plan, such distribution is potentially includible in gross income and to the extent includible, not only will it be taxed but an additional 10% surtax will also be applied. IRC §72(t) goes on to provide a dozen exceptions to the 10% surtax including IRC §72(t)(2)(A)(iv), "substantially equal periodic payments". More important at this point in the discussion is IRC §72(t)'s definition of a "qualified retirement plan" or QRP.

Our next stop is IRC §4974 to understand the precise definition of a QRP. IRC §4974(c) says in part, that QRP's include "an individual retirement account described in section 408(a)¹⁶³." In summary, traditional IRAs are definitionally included as a type of QRP and are therefore subject to taxation under IRC §72(t).

Next we need to similarly examine Roth IRAs which are governed by different code sections¹⁶⁴. IRC §408A says in part: "except as provided in this section, a Roth IRA shall be treated...in the same manner as an individual retirement plan...(b)...the term "Roth IRA" means an individual retirement plan (as defined in section 7701(a)(37))..." The question then arises, is an individual retirement plan, IRP, the same or different than a QRP? To answer this question, we next visit IRC §7701(a)(37) which says that an IRP is "an individual retirement account described in section 408(a)."

¹⁶³ IRC §4974(c)(2)(4).

¹⁶⁴ Certainly confusing; traditional IRAs are governed by IRC §408(a); Roth IRAs are governed by IRC §408A.

. To summarize, unless we can find an exception in IRC §408A¹⁶⁵, a Roth IRA is to be considered the same as a traditional IRA defined in IRC §408(a).

In sum total, we travel through at least five different code sections (IRC §§ 72, 4974(c), 408(a), 408A & 7701(a)(37)) all to learn that QRPs, IRPs, IRAs and Roth IRAs are all the same thing. Said another way, for purposes of applying IRC §72(t), a traditional IRA and a Roth IRA are treated in the same manner unless a specific exception can be found in IRC §408A.

Lastly, taxpayers have always had the option of treating their IRAs discretely or logically combining them for purposes of computing distributions under IRC §72(t). Therefore, albeit at first appearance illogical, we came to the conclusion that one may combine a traditional IRA with a Roth IRA for purposes of computing substantially equal periodic payments as defined in IRC §72(t)(2)(A)(iv). Thus, the fundamental question #1 posed at the opening of this section is yes.

The next subject to address is the includibility in gross income and therefore taxability of distributions. Here we look to some old sources as well as new¹⁶⁶. Unfortunately, all of the sources mentioned are written in the context of required minimum distributions for taxpayers over the age of 70 ½. There are no regulations specifically written to answer the includibility in income question for taxpayers under age 70 ½ when the issue at hand is the logical combination of a traditional IRA and a Roth IRA. However, there are some specifics that can help us:

- (1) IRC §408(a) says to apply the rules found in IRS Reg. §1.401(a)(9).
- (2) Logically, Reg. §1.401(a)(9) says two important things:
 - (A) To combine all IRAs into one logical IRA for purposes of computing required minimum distributions, but then affords the taxpayer the luxury of withdrawing the amounts needed from any one or more of the IRAs in order to meet the distribution.
 - (B) to tax the IRA distribution(s) pursuant to IRC §72(t).
- (3) IRC §72(t) says to fully tax, as ordinary income (and potentially surtax it as well), any distribution that is includible in gross income.
- (4) IRC §72 tells us that we need to annually compute the “exclusion ratio” based on the taxpayer’s investment in the contract¹⁶⁷ to determine the what portion of a distribution is

¹⁶⁵ Actually, we will find exceptions in IRC §408A, but no to the fundamental character of how to treat with IRAs defined in IRC §408(a) versus IRC §408A.

¹⁶⁶ IRC §72, §408(a), §408(d)(2) & IRS Reg. §1.401(a)(9).

¹⁶⁷ In this case, IRC §72 was originally drafted with annuities in mind. In our situation, the same concept applies, however, “investment in contract” means the same thing as “basis in account”.

includible in income.

- (5) IRC §408(d)(2) basically says to aggregate all of one's IRAs and aggregate all of one's distributions and treat as one. However, IRC §408A(4)(A) overrides this rule by saying: "§408(d)(2) shall be applied separately with respect to Roth IRAs and other individual retirement plans."

Again, to summarize, when a taxpayer combines several IRAs together to form the basis for SEPP distributions, one needs to track both the aggregate value of those accounts as well as the taxpayer's basis in one or more of those accounts; then, apply the exclusion ratio to determine what portion of the actual distribution made is to be included in gross income. As an example, assume a SEPP plan covering two IRAs¹⁶⁸ whose aggregate value at date of computation is \$1,000,000. Based on the lifetime-to-date contribution history to these IRAs, we establish that the taxpayer has made \$50,000 of non-deductible contributions. Lastly, the SEPP plan mathematics call for an annual distribution of \$60,000. The exclusion ratio is simply \$50,000 divided by \$1,000,000 or 5%; therefore, when the \$60,000 is distributed, \$57,000 is includible in gross income and \$3,000 is excluded from gross income. After the distribution is made, the taxpayer has a remaining basis in the account of \$47,000. Jumping forward a year, the account balances might grow to \$1,080,000. Thus the exclusion ratio for year two is 4.35185% ($\$47,000 / \$1,080,000$) or 2,611.11.

Each succeeding year the exclusion ratio is re-computed and generally gets smaller and smaller to the extent that the aggregate account balances remain static or grow. The last step is the taxpayer is required to complete Form 8606¹⁶⁹ to explain to the IRS how the exclusion ratio was computed and therefore identify the includible and excludible income amounts.

Lastly, we need to return to IRC §408A to see if there are any rules that might conflict and there are some:

- (1) IRC §408A(d)(4) Aggregation and Ordering Rules says "IRC §408(d)(2) shall be applied separately with respect to Roth IRAs and other individual retirement plans".
- (2) The same section goes on to say: "For purposes of applying this section and section 72 to any distribution from a Roth IRA, such distribution shall be treated as made (i) from contributions to the extent that the amount of such distribution, when added to all previous distributions from the Roth IRA, does not exceed the aggregate contributions to the Roth IRA...".

¹⁶⁸ At this point, what type of IRAs these might be is irrelevant as we have already established that all IRAs are treated identically.

¹⁶⁹ Form 8606 is required to be completed and filed each year. However, this form has many purposes and can be confusing. A short hand and simpler version can be found in Publication 590, "Worksheet 1-5. Figuring the Taxable Part of Your IRA Distribution", page 39.

For the first time we have some rules that force us to think and treat traditional IRAs and Roth IRAs differently. Fortunately, the rules work predominately in our favor. This section essentially says that when actually making a Roth IRA distribution, do not apply the §72 exclusion ratio; instead apply (2) above which reorders the distribution dollars from “ratable income recognition” to contributions come out first until exhausted and after contributions are exhausted, then income recognition commences.

Therefore, returning to the example earlier, to the extent that the taxpayer made the actual \$60,000 distribution from the Roth IRA, it would be logical to conclude that the first \$50,000 would be distributed tax free as a return of contributions followed by \$10,000 includible in income. However, what about the reverse, e.g. the taxpayer makes the \$60,000 distribution entirely from his traditional IRA in which he has no basis. Does the exclusion ratio apply and therefore \$57,000 is taxable and \$3,000 is not; or, is all \$60,000 taxable? Unfortunately, we are in “no man’s land”, as there does not seem to be any rules or regulations on point. Further, it appears that the regulations did not contemplate this type of situation; e.g. use of the Roth IRA in SEPP plan distribution computation but not actually making a distribution from the Roth. As a result, we can contemplate three different paths of action:

- (1) Apply the exclusion ratio as required by IRC §72. This path has several possible outcomes: (a) the taxpayer is never audited, thus we never really learn the right answer; (b) taxpayer is audited and is found to be correct; thus no additional tax is due; (c) taxpayer is audited and found to be incorrect; thus taxes, penalty and interest will be assessed for the tax years audited.
- (2) Do not apply the exclusion ratio therefore declaring 100% of the distribution as taxable income. Similarly, this path has several possible outcomes: (a) the taxpayer is never audited, thus we never learn the correct answer; (b) taxpayer is audited and found to be correct, thus no additional tax is due; (c) taxpayer is found to be incorrect and is invited to file amended returns for a refund; however, amended returns can, in general, only be filed for the last three tax years. Thus, in this instance, the taxpayer would be barred from recovering over paid taxes from earlier years.
- (3) As soon as possible, file for a private letter ruling to affirmatively reach a conclusion on this issue; at least early in terms of SEPP plan years.

As mentioned earlier, we are in no-man’s land on this question so I can not offer conclusive evidence or a hard opinion as to what is correct. However, the author’s opinion favors (3) above followed by (1) above. We are professionally anxious to see the question answered definitively, thus leaning to (3) above; however, it is equally understandable that the taxpayer may not want to incur the time and expense involved or may otherwise have other mitigating factors that might preclude this course of action. Thus, secondarily, we favor (1) above. Although (1) above is the more aggressive approach, the downside risks are minimal. The SEPP plan itself would never be in question (in which case the downside risks can become substantial) rather, the only question here is full versus partial taxability of the annual distributions. In the example used earlier, there might be an additional \$10,000 of reportable income over three tax years. Assuming the worst case, this might accumulate to an amount due in the \$7,000 range including the taxes due, penalties due plus interest.

Thus, to summarize, but for the discussion immediately above, if a taxpayer combines a traditional IRA and a Roth IRA for SEPP plan purposes, the taxpayer will, by definition¹⁷⁰, have an excludible component to their annual distributions under the plan.

The last issue to tackle are recapture taxes. IRC §408A(d)(3)(F)(i) imposes a recapture tax on Roth distributions, originating from a rollover, “made within a 5-taxable year period commencing with the taxable year in which such contribution was made”. There actually is logic for this code provision. In its absence, everyone would periodically convert dollars from a traditional IRA to a Roth IRA; then make an immediate distribution from the Roth IRA and pay no additional taxes; in short, an end run around the 10% surtax imposed by IRC §72(t). Now that we know why this provision is here, does it apply? I think not in that IRC §408A(d)(4) specifically tells us to think & treat Roth IRA distributions differently than all other IRA distributions. Thus, I come to the conclusion that the recapture tax imposed by this section does not apply as long as the actual distribution is made from the traditional IRA; conversely, I think this recapture tax¹⁷¹ would apply if the actual distribution were made from the Roth IRA itself subject to the 5 year rule.

INVESTMENT EXPENSES

As a general rule, expenses incurred in the production of income are deductible. In this regard, we can group typical investment expenses into two categories: (a) mutual fund load & back-end fees, trading costs to purchase or sell specific securities, and any other expense or payment that is specifically tied to purchase or sale of a specific security; (b) general production of income expenses; e.g. account maintenance fees, investment advisory fees, as well as the more general expenses associated with investment decision-making such as: subscriptions, books, etc.

Type (a) expenses; those associated with the purchase or sale of a specific security are not deductible; instead, all of these expenses are added to the taxpayer’s purchase basis or netted against sale proceeds as the case may be.

Type (b) expenses; the general production of income expenses which are not associated with purchase or sale of a specific security are deductible¹⁷²; however, they are subject to a 2% of adjusted gross income floor¹⁷³ which inevitably will remove some portion of one’s itemized deduction.

¹⁷⁰ All contributions made to a Roth IRA are non-deductible contributions, therefore the taxpayer must have basis in the account.

¹⁷¹ E.g. go right back to IRC §72(t) and apply the 10% surtax as if the distribution had really been made from a traditional IRA.

¹⁷² See IRC §212(1) “in the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income”

¹⁷³ See IRC §67(a).

Further, in order to deduct these expenses, a variety of tests must be met:

- (1) First and foremost, the taxpayer must itemize their deductions using Schedule A of Form 1040. No deduction is allowed here for short form or standard deduction filers.
- (2) The expense must be “paid or incurred” by the individual taxpayer. In this case it is a literal interpretation. As a result, many brokerages & investment advisory / management services provide an option to the taxpayer, with specific respect to IRA accounts: whether the taxpayer would like to pay these fees directly or whether the fees should be deducted directly from the IRA account. In the former case, the taxpayer has directly paid or incurred an expense & it is therefore deductible. In the later case, the taxpayer HAS NOT paid or incurred the expense; therefore, there is no expense to be deducted. The IRA account is technically not owned by the taxpayer; rather the IRA is owned by the trustee & the trustee owns / holds the IRA account for the future benefit of the taxpayer.
- (3) There is no income recognition or realization test; e.g. the taxpayer need only pay or incur the expense. There is no requirement that the expense actually result in the current period recognition of income or any income at all¹⁷⁴; e.g. some advice is good and results in current or future period income; some advice is bad and results in losses.
- (4) The expense paid or incurred must be considered “ordinary and necessary”¹⁷⁵. Thus, such expenses must be considered reasonable in amount and must bear a reasonable and proximate relation to the production or collection of taxable income.

Number (4) above is critical. For the expense to be deductible, the relationship between the expense and the production of income need only be “reasonable & proximate”; it need not be direct and it need not be allocated or apportioned. Some examples of deductible expenses are probably in order:

- (1) Investment advisory fees.
- (2) Software / Internet subscription for an on-line quotation service.
- (3) Investment magazines.
- (4) Annual account maintenance fees.
- (5) Distribution fees.
- (6) Postage or other delivery expenses associated with the filing of a “proof of claim” related to an investment security; even travel expenses associated with attending the trial in an attempt to collect from the Enron Board of Directors.
- (7) Depreciation on your home computer which is used exclusively (or at least

¹⁷⁴ IRC Reg. 1.212-1(b): “The term income for the purposes of §212 included not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent in subsequent taxable years.”

¹⁷⁵ IRC Reg. 1.212-1(d).

predominately) for online trading, tracking of investments, etc.

Further, here are some examples of expenses which are not deductible:

- (1) Any fee or expense from above that is not paid or incurred by the taxpayer. As a result, if the fee is deducted directly from the IRA account, it is not deductible; conversely, if the fee is deducted directly from a regular brokerage account, it is deductible as the regular account is owned by the taxpayer.
- (2) Generally, the cost of attending any investment seminars (typically in warm places; usually on a big device that floats in the water).
- (3) An expense that would otherwise be considered ordinary & necessary, but is used in the production of tax-exempt income. Remember that IRAs and other deferred accounts are “tax deferred” NOT tax exempt¹⁷⁶.

This whole subject of investment expenses is technically unrelated to SEPPs; however, the question frequently comes up where a taxpayer has chosen to hire an investment advisory service that charges a fee based on assets under management; typically in the range of 1% per year. If you have such a relationship and have a \$1,000,000 IRA; this amounts to \$10,000 per annum in advisory fees on your IRA. The \$10,000 can be deducted directly from the IRA in which case the distribution IS PERMITTED and is in no way considered a modification or extra distribution that would invalidate the SEPP plan. Conversely, the taxpayer may pay the \$10,000 directly in which the \$10,000 is deductible as a miscellaneous itemized deduction subject to the 2% adjusted gross income floor on Schedule A.

INVESTING IN REAL ESTATE

What does investing in real estate have to with SEPP plans? In a direct sense, absolutely nothing. In an indirect sense, a lot. Further, this question just seems to come a lot from taxpayers contemplating SEPP plans. As a result, it seemed prudent to at least touch on this subject.

IRC §408(m) is the only Code section that tells us what IRAs can not invest in¹⁷⁷. In this case its focus is collectibles, e.g. works of art, rugs, antiques, metals, gems, stamps, coins, alcoholic beverages and other personal property as defined by the Commissioner. Noticeably absent from the list is real estate; therefore real estate investments are permitted to be made from IRA accounts. Our next stop is IRC Reg. 1.408-1(c) which contains to very important provisions:

¹⁷⁶ This raises an interesting question. Are ordinary investment expenses allocable to a Roth IRA deductible? Qualified Roth distributions are not includible in gross income; e.g. tax free; however, unqualified Roth distributions are includible in gross income subject to the ordering rules. Therefore, we come to the conclusion that investment expenses for a Roth IRA are deductible at least to age 59½.

¹⁷⁷ In this case, the IRC defines impermissible investments as deemed distributions which has the same effect.

- (2) Prohibited transactions by the owner or beneficiary of the IRA.
- (3) Prohibited transactions by a person other than the owner or beneficiary of the IRA.
- (4) Pledging the account as security.

(2) and (3) above, to paraphrase the Regulations are the “prohibited transactions”, “disqualified person” or sometimes called “self-dealing” regulations. For our purposes here a disqualified person¹⁷⁸ means the account owner and the beneficiary as well as all: spouses, ancestors, lineal descendants and any spouse of a lineal descendant; in short, everyone in your immediate family is considered a disqualified person. These same regulations tell us that any direct or implied transaction or transfer of benefit to or from the account between the account and a disqualified person is a “prohibited transaction”. Further, a prohibited transaction is essentially treated the same as a distribution (therefore subject to regular income tax plus the §72(t) 10% surtax) plus a 100% surtax. Let’s repeat that. An IRA that engages in a transaction with a disqualified person causes the transaction (let’s say its worth \$10,000) to become a disqualified transaction; therefore, regular income tax is due (let’s say \$2500); plus the surtax is due (\$1000); plus the IRC §4975 prohibited transactions tax of \$10,000. Total tax due: \$13,500!!!

\$13,500 is at least 11,000 reasons to absolutely never, ever (in)advertently get tangled up in a prohibited transaction. This makes real estate investing from an IRA very dangerous because some prohibited transactions are not necessarily obvious. Let’s assume that you instruct your IRA to purchase a condominium on the beach and further, you instruct the management company to rent out your condo as part of their rental program. During the next five years, you:

- (1) Stay in the condo for free (only paying a cleaning charge) one or two weeks per year.
- (2) Bought new linens for the beds or hung a picture on the wall.
- (3) Painted a wall or two.
- (4) Invited your sister-in-law to stay for a week, no charge.
- (5) Helped the condo management company by helping to collect some unpaid rent on your unit.
- (6) Slipped up and paid the electric bill from your personal funds instead of the IRA paying it.
- (7) Supervised the remodeling of the kitchen.

Every one of these transactions is necessary, ordinary & normal for the condo at the beach. Every one of these transactions is a prohibited transaction. In every case, you are a disqualified person and in every case there is either an explicit or implicit transaction of some value occurring between the IRA and a disqualified person; therefore it is a prohibited transaction; therefore pay up!

So how does one directly invest in real estate yet avoid these prohibited transactions? You will need two helpers: a trust company and a management company. If you call up your friendly broker where ever your IRA is located and ask the broker to take title to the condo in your IRA, he will say no; he can not do it. Instead, you will need to seek out a trust company willing to accept your IRA and further willing to accept title of the condo in the IRA. These trust companies are actually rather

¹⁷⁸ See IRC §4975(e)(2)(F) & (G).

easy to find. Just drive around town (usually the town where the condo is located) and start looking at the names of what you would think of as a bank. If their name is 1st National Bank Of Condoland; then they are not a trust company. If their name is 2nd State Bank & Trust Company of Condoland; then they are a trust company. It's the "& Trust Company" in the title that makes them a trust company, registered under the Trust Company Act and required to advertise as such. So now you have found a trust company who will take title of the condo for your IRA. Unfortunately, trust companies do not do this for free; they will charge a fee, anywhere from ½ % to 2% of the assets under management. Further, from your perspective, they don't do anything except maintain the trust and that only takes one hour per year.

Your next helper is the property management company. They actually do everything; collect the rents, pay the bills, do the repairs, etc. and most likely monthly, submit a bill for their services to the trust company. Their fees can easily be material, although it is all relative to the value of the investment. It is really the management company that stands in your stead, gets the real work done, and keeps you from inadvertently executing a prohibited transaction.

As a result, investing in real estate is not impossible, far from it. Rather, simply recognize that two other parties, both of whom need to be compensated, need to be present to make sure everything goes smoothly.

Most of us, when thinking about real estate, think about leveraged real estate; e.g. the mortgage. Real estate purchased in your IRA must be a "cash-on-cash" transaction — no mortgage allowed. IRC Reg. 1.408-1(c)(4) prohibits pledging of an IRA or the contents of an IRA as security¹⁷⁹, such as in a lending transaction. As a result, if as part of the purchase of the condo, you obtain a mortgage, the mortgagor is going to look to one of two places to secure their interest before they will make the loan: (1) they will look to the property itself; (2) they will look to you. Both of these are prohibited. In the former, an IRA asset has been pledged as security in a lending transaction; in the later the IRA has inured indirect benefit from a disqualified person — you. As a result, direct real estate investments by IRAs must be 100% cash transactions.

Lastly, real estate investing poses some cash flow and valuation issues with respect to SEPP plans:

- (1) What if John's \$1,500,000 IRA is really comprised of 10 condos on the beach, all of which are performing well at the moment. He launches his SEPP plan at \$80,000 per year when the cash flow from the condos is providing a \$100,000 per year? Good deal; at the moment. Three years later, the country is in a recession and the condos are not renting out as they should, therefore only providing \$40,000 per year in cash. John needs to make his annual distribution of \$80,000 and the cash just isn't there, what does John do? He has two, mostly unpalatable choices: one, bust the SEPP plan incurring the

¹⁷⁹

As an aside, it is this same regulation that prohibits certain other securities transactions; e.g. writing/selling a naked call; and entering into a margin agreement on an IRA account. Both of these transactions cause the IRA contents to be pledged as security against the transactions executed.

10% surtax plus interest; two, sell a condo or two, most likely at the absolute wrong time in order to create the cash needed.

- (2) Irrespective of the SEPP plan method chosen: minimum, amortization or annuitization, the first and most important variable in the formula is always account value as of a date. How does John value his 10 beach condos? Easy, he hires a real estate appraiser who expects to be paid. Further, if John is using the minimum method or annually recalculated amortization method, John has to hire a real estate appraiser EVERY year in order to get an IRA account value very year. This, needless-to-say, can get expensive.

In short, real estate investing has not been made illegal, just very difficult and intentionally so. This author is not against real estate investing inside of IRAs but would counsel that SEPP plans and real estate are just not very compatible and should be left for another day.

TRAILER MONEY

Trailer money can become a problem with an extant SEPP plan if not properly handled. However, 1st let's define the sequence of events that cause trailer money to appear:

- (1) Taxpayer separates from service from employer (let's say in September).
- (2) Taxpayer requests a qualifying lump sum distribution from his §401(k) plan and receives funds in November; or the plan administrator simply sends all of the money directly to the taxpayer's rollover IRA account.
- (3) Taxpayer values the rollover IRA account as of December 31st and launches a SEPP plan effective January 1st; commencing monthly distributions of some amount.
- (4) In Mid-May, taxpayer gets a letter from the plan administrator with a check attached in the amount of \$1,256.78 with little or no explanation of why this check is being issued; just that it is additional funds due the plan participant.

\$1,256.78 is a non-diminimus amount; e.g. it is sufficiently significant that the taxpayer has to do something; however, what to do is unclear: Is it principal or earnings? Into what account should it be deposited? Does it affect the 12/31/xx SEPP account valuation? Is the SEPP plan now screwed up? All of these a valid questions. Unfortunately, there are absolutely no rules or regulations on this subject. Essentially, trailer money was never anticipated by the Internal Revenue Code or the Internal Revenue Service. Thus, all we can do is look to other, typically unrelated, Code sections plus a heavy measure of common sense to figure out a set of reasonable rules.

In this regard, the author would suggest that two issues are important: knowledge and transaction character. Both of these issues can provide guidance. For example:

- (1) John has a §401(k) account with a 10/31/xx balance of \$1,500,000 & instructs the plan administrator to distribute \$1,400,000 to his rollover IRA account from which John launches a SEPP plan. The following May, for whatever reason, the plan administrator distributes \$101,256.78 (the last \$100,000 plus interest earned of \$1,256.78). **This is NOT trailer money** and therefore does not belong in the SEPP IRA account. John had knowledge of the \$100,000 and specifically did not transfer it to his SEPP IRA.
 - (A) If John gets the check directly, he need only deposit it to another IRA account, not the SEPP IRA account at the financial institution of his choosing.
 - (B) If the check was sent directly to the SEPP IRA, John must promptly get those funds out of the SEPP IRA into another account. In this case, the author would suggest prompt as being defined “as within 60 days”.
- (2) Same circumstance as (1)(B) above, however John doesn’t tend to read his monthly statements and the amount resided in his SEPP IRA account for seven months. In this case, the author would suggest that an interest/earnings computation be made, e.g. on average over last seven months, excluding distributions, the entire SEPP IRA account grew by 5.67%; therefore move \$1,328.04 ($\$1,256.78 * 1.0567$).
- (3) John requested a qualifying lump sum distribution (meaning 100%) of his §401(k) account & accordingly, the plan administrator sent a check for \$1,504,238.66 directly to John’s rollover IRA account in November. John values the account at 12/31/xx and launches a SEPP plan with monthly distributions commencing in January. In May, John’s rollover IRA account gets an additional deposit in the amount of \$1,256.78:
 - (A) The deposit comes with no explanation. John has no prior knowledge and has no information as to the transaction’s character. As a result, John should simply treat the funds as additional earnings further treating those earnings as earned in the current year; therefore no need to restate the 12/31/xx balance on which the SEPP distributions were based.
 - (B) The deposit comes with any of several explanations: (1) prior year earnings; (2) as a result of other employee forfeitures; (3) his apportionment from a lawsuit settlement; (4) refund of excess fees charged by a mutual fund. Each of these cases is possible, plus a dozen more. In all cases, John had no knowledge but does now have detailed information as to the transaction’s character. Similar to (3)(A) above, simply treat the additional deposit as current year earnings.

Numerous additional examples are always possible; however, hopefully the reader gets a theoretical outline: look at what you knew at the beginning of the transaction stream and further look at the character of the trailer money to the extent determinable. As a general rule, but it is only a general rule, trailer money is almost always less than 1% of the amount originally distributed. If you receive a following distribution that exceeds 1% of the amount originally distributed, it is likely not trailer money and requires immediate attention.

THE BIG MISTAKE

Let's assume John was 54 and had been gainfully employed for the last 30 or more years. Even better, John was an early saver in IRAs, §401(k)'s, §403(b)'s & even a Roth IRA or two. For three decades, he was a faithful saver. Even better than better, John had been exclusively, or at least predominately, a growth styled investor, investing both domestically and around the globe. Further, for most of those 30 years he had been handsomely rewarded to the point where the accumulation of the deferred assets has just hit \$2.5 million.

With gold watch and 30 year service plaque in hand, and the sage advice of your personal financial planner, John & his better half decide that its time to start the enjoyment phase of their lives. Further, he created a substantially equal periodic plan to withdraw \$200,000 annually. This was not an unreasonable plan back in 1999 or 2000. The first distribution took place 1/1/2000.

Fast forward to 1/1/2003; the account is now worth approximately \$500,000. 80% of the market value from 36 months ago has vanished. How is this possible? His financial planner told him that his plan was okay however, this is clearly NOT okay. His account can't possibly last another three years, much less another 30 years. What went wrong?

During the period 1/1/2000 to 1/1/2003, the NASDAQ was down cumulatively by 65%. During that same time period, John disbursed 24% of the account principal to himself. In this example, we simply disbursed 1st and took market losses 2nd so that the total depreciation in the account balance was only 80%; reverse the process and take market losses 1st and disburse 2nd and the total account depreciation becomes 90%. Bottom line, a mere 36 months later the IRA account balance is somewhere in the \$250,000 to \$500,000; a mere fraction of what took over thirty years to build. Where was the error?

The error lies in how the corpus or principal of the IRA was invested. For thirty years, growth stocks worked well; sometimes just well, sometimes really, really well. Further, John did not need or want any of that money during those thirty years; instead the whole purpose behind the IRA was grow, grow and grow some more. On 1/1/2000, John assigned his IRA a new task; better said, he assigned his IRA a new master ---- create income for me! But John did not change how he invested the underlying monies in the IRA; he either ignored the issue or said to himself that growth worked for the last thirty; it should still work reasonably well for the next thirty. He failed to see the conflict between the investments and the newly changed account objectives. Said another way, when the account horizon is decades and the objective is growth; then invest in growth; when the account horizon is year-to-year and the objective is income; then invest in income.

What if John had switched to 75% income vehicles (some mixture of Treasury's, corporate bonds, REITs and preferreds) and left 25% in growth oriented common stock. What would John's portfolio be worth today? Depending on what assumptions you might make; somewhere between 90% and 110% of the original value. John would still be on a warm beach enjoying himself.

Instead, John, now 57, is scouring the newspapers and re-activating his personal network looking for a job. One simple error virtually destroyed 30 years of work. In this instance,

forget the mathematics, forget whatever Revenue Ruling 2002-62 says; focus on aligning the investments in your portfolio to match the desired objective.

The author apologizes for preaching here; however, just ask one question: why is it that the Revenue Ruling 2002-62 permits a one time change to the RMD method without penalty? It seems unusual. It seems as though IRC §72(t)(4) should apply; e.g. it's a modification to the payments, therefore the penalties and interest should apply. Why did the IRS give us this exit strategy? The answer is simple. The IRS, like a tree, bent with the winds, and the (political) winds were blowing at gale force by mid-2002. The IRS understood the problem clearly; they also understood that they had no tools at their disposal with which to mandate how people invest; lastly, in the midst of one of the worst stock market corrections in our lives, they did not want to be the ogre — sorry John, not only have you exhausted your IRA, you effectively broke & looking for a job; by the way, here is an extra \$100,000 tax bill on your early withdrawals.

CHAPTER 7 - RISK ANALYSIS

RISK ASSESSMENT

Every taxpayer is exposed to two types of risk when implementing a SEPP program:

- An individual's SEPP program may be found to not comply¹⁸⁰ with IRC §72(t)(2)(A)(iv) & Revenue Ruling 2002-62 at some point; resulting in the application of the 10% surtax and intervening periodic interest.
- If one's SEPP program is challenged, the taxpayer may choose to expend the additional economic resources necessary to prevail against the challenge instead of paying the penalties and interest.

Each taxpayer can rather easily compute the dollar value of these risks based on his own individual facts and circumstances. As an example, we discussed penalty computations back in the Common Concepts chapter. Let's look at John again who commences a SEPP program now at age 52. This program will run for eight years at \$50,000 a year. What's John's maximum exposure? A quick glance back at the penalty table tells us his maximum penalty and interest combined is in the \$50,000 range. Can John afford to pay the \$50,000 eight years in the future? Even if John can afford to pay it, how would John feel about it?

What, if anything, should John do to mitigate this risk? The author would like to suggest that John has three potentially different paths he can pursue --- risk assumption, risk transfer through the purchase of insurance and risk removal. Each of these tactics comes into play at differing levels of dollar risk as well as SEPP program aggressiveness.

- Risk Assumption means that the taxpayer personally assumes the risk of penalty. The taxpayer has two tools at his disposal should he choose to assume the risk. One, the taxpayer can intentionally design a SEPP program of a lesser dollar value than he might otherwise and therefore decrease the dollar value of the corresponding risk. Two, the taxpayer can intentionally design a less risky (meaning less aggressive) program that would appear to be more safe and palatable to the IRS upon examination. Unfortunately, individual risk tolerance is a very personal matter such that there are no pat answers here.
- Risk Transfer is the same as purchasing insurance. Unfortunately, your local insurance agent does not offer "SEPP penalty" policies. However, there is something that is almost as good. All competent practitioners in the tax arena, both CPAs and lawyers, invariably carry "errors and omissions" insurance coverage. As a result, if the taxpayer

¹⁸⁰ This would most likely result from a specific or compliance audit performed by the IRS. Although the actual likelihood of being audited is low, this author never recommends playing the lottery; e.g. assuming a non-compliant SEPP program will survive simply because you will never be audited or if audited, the IRS auditor will miss whatever is non-compliant.

so chooses, he can have his program designed and reviewed by a licensed CPA and/or tax attorney. This design, and more importantly the review, by your chosen professional should include a written opinion letter from that professional that indicates that he or she believes that the program, as designed, is in compliance with all provisions of IRC §72(t). In the advent that the SEPP program is found to not comply, the taxpayer has recourse against the professional for having committed a professional error or omission¹⁸¹. Further, taxpayers should not hesitate to discuss this very issue with any professionals they chose to employ as well as discuss their policy limits and how claims are made. Depending on the complexity of your SEPP program, professional tax accountants and lawyers may charge as little as \$500 to as much as \$5,000 for design, review and opinion of a SEPP program.

- Risk Removal is the elimination of the risk itself. The only way to remove this hazard is to go to the Internal Revenue Service and preclude them from finding your SEPP program non-compliant. The process is called a private letter ruling request. As its name implies, it is a letter from the IRS to you (and only you) indicating that the IRS has reviewed your facts, circumstances, program design and proposed future transactions, and --- in their opinion --- rule that your SEPP program is compliant¹⁸². In the event of an audit, the taxpayer need only produce the private letter ruling and all IRS examiners will immediately proceed to the next topic of examination on your return. Obtaining a private letter ruling is not as onerous as one might think. The costs associated with obtaining a ruling are twofold: one, payment of a filing fee to the IRS¹⁸³; two, payment to a professional tax accountant or tax attorney to prepare the actual filing¹⁸⁴. Professional fees can easily be in the range of \$3,000 to \$10,000. Depending on the aggressiveness, and therefore the risk associated with your proposed plan, it is not uncommon for a professional to indicate that the plan risk factors are beyond his or her tolerance and therefore a private letter ruling is called for.

With these three tools for risk mitigation, which of the three should a taxpayer use. As

¹⁸¹ Let's take a simple situation. You engage a CPA to design your program resulting in the first distribution in 2003. Further, your professionally designed program uses the old annuity method and a 7% interest rate assumption. What happened here? Your CPA was two or three months or so behind in his or her reading and was not yet up-to-date on Revenue Ruling 2002-62. Three years from now you are audited and your SEPP program is found to non-compliant; therefore you are assessed \$13,162 in penalties and interest. You have to pay it; but, your CPA should reimburse you for having committed a professional error. In the case of a prima facie error such as this, you would most likely get a check in the mail directly from your CPA's insurer.

¹⁸² This is ultimate "Get Out Of Jail Free" card.

¹⁸³ For 2004, the filing fees are either \$625 or \$2,570 depending on whether your gross income during the year of filing is under or over \$200,000 respectively. See Revenue Procedure 2004-8; Section 6. Fee Schedule, pages 243-244.

¹⁸⁴ This author suggests that individual taxpayers not attempt to prepare their own filings. A PLR is a highly regulated and stylized document. In addition, the professional experience of your CPA or lawyer will create a better filing which will have a higher probability of success.

usual, there is no clear cut answer particularly taking into account the varying levels of taxpayer risk tolerance. However, following is a chart of program design risks so that each taxpayer can get some sense of risk regarding his or her tentative program design.

SEPP PROGRAM DESIGN RISKS			
	Low	Medium	High
Required Minimum Distribution Method			
With annual recalculation	X		
Without annual recalculation			X
Use of approved life expectancy table	X		
Use of unapproved life expectancy table			X
Use of 12/31/XX balances for recalculation	X		
Use of other balances for recalculation		X	
Switching life expectancy tables between years			X
Amortization and Annuitization Methods			
Interest rate less or equal to 120% mid-term AFR	X		
Any other interest rate			X
Use of approved life expectancy table	X		
Use of unapproved life expectancy table			X
One-time beginning of plan computation	X		
Annual recalculation		X	
Spousal Death	X		
Divorce with step-in-stride plan continuation	X		
Divorce with plan modification		X	
Multiple SEPP programs		X	
1 st Year Stub Period	X		
Account Valuation Dates			
Within 3 months of 1 st distribution	X		
Within 4 to 11 months of 1 st distribution		X	

12 months or more			X
On other than a month-end		X	
Account Universe			
Attempting to add to			X
Attempting to remove from			X
Attempting to merge when multiple SEPPs are running			X
Cost of Living Increases			
Fixed 1% to 3% per year			X
Fixed greater than 3%			X
Relative			X
Electing one-time switch to the RMD method			
At a year-end	X		
Pro-rata mid-year		X	
Putting money back into the IRA to implement RMD			X
Retroactive actions of any kind			X
Cessation of plan distributions			
IRA has zero dollars remaining in it	X		
IRA has remaining assets above \$1			X
Other plan interruptions and modifications			X
New computational methods			X
Undocumented SEPP plan		X	

Needless-to-say, the allocation of any one action or feature into the “low”, “medium” or “high” risk category is somewhat subjective and represents the opinion of the author. Further, we would like to say that there is some magical scoring system that one could apply; unfortunately, no such magic exists. Instead, each taxpayer will need to assess a combination of factors simultaneously; personal risk tolerance, dollar magnitude and overall program risk level.

Many individuals are thoroughly capable of designing and implementing their own SEPP programs; an equal number are not. Each taxpayer should self-evaluate and determine his or her abilities to go it alone versus seeking professional assistance. Generally, those individuals who are mathematically facile, are comfortable with this text and the process, and have designed a low to

medium risk program will be fine on their own. An absence of confidence in any of these areas is probably cause to seek some level of outside assistance.

SELECTING A PROFESSIONAL

Many taxpayers will choose to either consult with a professional to obtain an outside opinion or may potentially turn the whole project over to the professional. How does the average taxpayer select a competent professional?

The average taxpayer, having read through this text to this point, knows more about substantially equal periodic payment programs and related IRC §72(t) issues than 99% or more of the practicing tax accountants and tax lawyers available in your area.

With this in mind, the taxpayer really has an easy job of selecting a competent professional. It goes without saying that a professional should be both licensed and insured as well as have the apparent signals of permanency and stability. After that, it is time for some test questions. Ask your prospective professional if he or she has ever issued an opinion letter to another client on §72(t) matters. Ask if they have submitted any private letter ruling requests on behalf of other clients & whether those PLR requests were successful. Ask if they have an opinion on Revenue Ruling 2002-62 and the ability of a taxpayer to implement plan features not discussed in the ruling. Ask if they have any thoughts on whatever you believe to be the most sensitive or riskiest design components of your proposed plan.

The answers you receive will, without question, be broad and, in many cases, test your own sense of amazement¹⁸⁵. In short, just through the posing of three or four questions, you will easily be able to differentiate between the competent and less than competent¹⁸⁶ professionals. Remember, as the client who is paying the bill, you want to hire not only a skilled professional, but also a skilled professional who has a high degree of experience dealing with your specific needs. Finally, the highly skilled professional accountant or lawyer will welcome you and your level of knowledge on SEPPs. You are his or her best client. On the presumption that you are going to hire a professional and pay his or her bill, there are several things you should request:

- You will receive a signed formal opinion letter on organizational letterhead.
- The opinion letter will contain a recital of the relevant facts, plan design, and will conclude with some language like: “It is my best professional opinion, upon which you

¹⁸⁵ This is the author’s method of forewarning readers that the concept of “bull-pucky” has never been limited to the sales and marketing professions.

¹⁸⁶ By no means am I suggesting that a professional who “back pedals” or even gives what you to perceive as a wrong answer is an incompetent professional. Rather, I am suggesting that they are less than fully conversant on the subject matter at hand and that therefore, you are best advised to seek professional help elsewhere.

may rely, that a SEPP program implemented¹⁸⁷ as described above is in compliance with IRC §72(t)(2)(A)(iv) and all other relevant IRS pronouncements.”

- You will have the opportunity to review or receive a copy of the professional’s errors and omissions policy declarations page.
- You will be free to replicate the opinion letter and distribute it to other interested parties such as: bankers, lenders, brokers, IRA trustees and custodians as well as the IRS.

Thus far, we have discussed using a CPA or tax lawyer as your chosen professional. There are several other possibilities including certified financial planners, “CFPs”; and enrolled agents, “EAs”. There are also several other poor choices, which include:

- Using your father-in-law, barber or auto mechanic. Most of these people will represent to you: “Oh, I’ve done that, it’s easy. Let me show you how.” When this occurs, immediately change the subject of conversation something less dangerous; such as politics or religion.
- Using your individual broker or related in-house retirement specialist. Brokers are supposed to sell good investments to clients and good brokers will restrict themselves to that function. It will be the very rare broker that is sufficiently knowledgeable on §72(t) to function as your outside professional. Instead, your broker will likely pass you on to the retirement department to speak with one of their specialists. **DON’T DO IT.** These retirement specialists are actually reasonably well trained, however, they have been trained to represent the brokerage company’s perspective and position on the subject, usually by inside counsel. In short, their interests are not your interests and may actually be adverse. Their perspective is one of permitting SEPP programs as long as that permission does not interfere or conflict with that entities responsibilities as a trustee and custodian of your assets.

¹⁸⁷ Please keep in mind that when hiring a professional, you are really asking the professional to opine on the design of the SEPP program, not its execution. Assuming the design to be excellent, but you the taxpayer do not execute correctly, then the professional is not at fault.

CHAPTER 8 - ADMINISTRATION

RECORD KEEPING

If there was ever a good time for record keeping, this is it. Once you have designed your SEPP program, you need to document it (we discussed a template for a self-contract in Chapter 6). The detail documentation should be designed to meet several needs: your own specifics, accountant's or lawyer's needs if you use one, and lastly for the IRS should the doorbell ever ring. The easiest way to do this is to use the contract from Chapter 6 as a beginning template. Then add to it any and all specific issues you think appropriate as well as all of your mathematical worksheets and copies of account statements.

The above really documents your plan design. Next, you should also document plan execution by logging all distributions from your SEPP IRA and copies of your 1099R's received. This is also a good cross-check / control mechanism to test, at least once a year, that what you expected to have happen, did in fact happen correctly.

TRUSTEE COMMUNICATIONS

These communications should always, always be in writing. Even if a phone conversation or e-mail seems to have handled your request, always write a follow-up letter to your trustee¹⁸⁸ confirming your agreement on steps and actions that are to occur. Unfortunately, there are a variety of professionals you will potentially deal with: trustees, account custodians, plan administrators, brokers, etc. All of these people and their respective institutions are considered your sub-contractors and agents. Thus, any error committed by any one of these entities effectively becomes your error¹⁸⁹. Sometimes these errors are correctable, sometimes they are not. Thus, why invite a difficult situation when a simple letter will suffice.

TAX MATTERS

The source from which you are withdrawing SEPP dollars must issue you a form 1099-R on or before January 31st for the year just ended. Other than the amounts being correct, the most important box on the form is "Box 7: Distribution Code". It should have a "2" in it. Referring to the guide for distribution codes, we find that a "2" means "Early distribution exception applies (under age 59 ½)(You need not file Form 5329)". Conversely, if box 7 is blank or contains any code other than

¹⁸⁸ In this case, we are using the word "trustee" generically to mean whichever responsible party you might be dealing with to execute SEPP transactions. This may be the actual trustee, a custodian, record keeper, a plan administrator, or your personal broker.

¹⁸⁹ A trustee or custodial error is not a valid defense to an IRS challenge to your SEPP program. The trustee or custodian may have professionally erred and you may have recourse against that person or institution after you have paid the IRS; just be prepared to prove it.

a “2”, you will be required to complete and file Form 5329¹⁹⁰.

Some trustees / custodians are willing to put the “2” in box 7 via a simple written request from you. Take care of this early in the year. Do not wait until you receive your 1099-R, see that it is incorrect, and then get on the phone. Other trustees / custodians will require more information before they will comply with your request (another good reason to have written yourself a thorough SEPP contract letter).

SEPP withdrawals are always reportable as unearned ordinary income, currently on lines 15a and 15b of IRS form 1040. If your SEPP withdrawal is 100% taxable, then the same amount goes on both line 15a and 15b. If you have basis in the account(s) from which SEPP withdrawals are being made, then place the total amount withdrawn on line 15a and the lesser taxable amount on 15b also completing Form 8606.

Taxes will always be due because SEPP withdrawals are always reportable as ordinary income. How much tax will be due has nothing to do with the SEPP withdrawal itself; instead, the amount of tax due is governed by the overall tax situation including all other sources of income as well as deductions and exemptions. There are two ways for taxpayers to meet their tax obligations in this regard. One, most trustees offer to withhold federal and state taxes from your distributions; not unlike the manner in which federal and state taxes were withheld from your paychecks when employed. The taxpayer has the opportunity to avail himself of this process or to decline. Second, taxpayers can always make quarterly estimated payments¹⁹¹ at the federal and state levels. If a taxpayer chooses to make quarterly estimated payments, we suggest that SEPPs be withdrawn on a ratable quarterly basis to match the estimated payment due dates. This causes the distributions and the tax payments to match up nicely and thus no need to separately explain uneven distributions.

STATE TAXATION

At the federal level, SEPPs are always treated as ordinary unearned income. This is not always the case at the state level. Some states¹⁹² offer whole or partial exclusions, credits or otherwise afford the taxpayer favorable tax treatment on SEPP distributions. The author is not suggesting that anyone should physically move states simply to take advantage of favorable tax treatment; however, it has been known to happen. Instead, some states, which might be considered “moderate tax states” all

¹⁹⁰ If you are required to complete Form 5329, please do not overlook it. In the absence of this form and an absence of the “2” in box 7, the IRS computers have a nasty habit of automatically issuing deficiency notices for 10% plus interest for the amount withdrawn.

¹⁹¹ Estimated tax payments are due 15 calendar days after the close of the somewhat illogical IRS definition of a quarter; April 15th, June 15th, October 15th and January 15th. Let’s see everyone count on their fingers and explain to me why June 15th isn’t July 15th.

¹⁹² Unfortunately this is an ever changing landscape; otherwise we would have been happy to provide a table of states with favorable treatment. This is a situation where it is very important to read those state income tax filing instructions. You don’t want to miss an income exclusion for which you are eligible.

of sudden start to look like “zero tax states¹⁹³” when a vast majority of one’s taxable income is from SEPPs.

THE END

My sincere congratulations on your making it through. It was a tough haul, but I hope you will think it was worthwhile. Needless-to-say, we attempted to think through SEPPs from every conceivable perspective in order to anticipate your every question. We hope we covered the first 98 questions so that you only have 2 left. We will be happy to answer those last two questions as well as your criticisms and recommendations. The author can be reached at themarblegroup@wispertel.net. The author is also a frequent poster on SEPPs as “TheBadger” on www.fool.com and www.72t.net.

¹⁹³ Colorado and Illinois immediately come to mind. There are most likely several more.

APPENDICES

APPENDIX A: INTERNAL REVENUE CODE §72(t)

10-PERCENT ADDITIONAL TAX ON EARLY DISTRIBUTIONS FROM QUALIFIED RETIREMENT PLANS.--

72(t)(1) IMPOSITION OF ADDITIONAL TAX.--If any taxpayer receives any amount from a qualified retirement plan (as defined in § 4974(c)), 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.

72(t)(2) SUBSECTION NOT TO APPLY TO CERTAIN DISTRIBUTIONS.--Except as provided in paragraphs (3) and (4), paragraph (1) shall not apply to any of the following distributions:

72(t)(2)(A) IN GENERAL.--Distributions which are--

72(t)(2)(A)(i) made on or after the date on which the employee attains age 59½,

72(t)(2)(A)(ii) made to a beneficiary (or to the estate of the employee) on or after the death of the employee,

72(t)(2)(A)(iii) attributable to the employee's being disabled within the meaning of subsection (m)(7),

72(t)(2)(A)(iv) part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of such employee and his designated beneficiary,

72(t)(2)(A)(v) made to an employee after separation from service after attainment of age 55,

72(t)(2)(A)(vi) dividends paid with respect to stock of a corporation which are described in §404(k) , or

72(t)(2)(A)(vii) made on account of a levy under §6331 on the qualified retirement plan.

72(t)(2)(B) MEDICAL EXPENSES.--Distributions made to the employee (other than distributions described in subparagraph (A), (C) or (D)) to the extent such distributions do not exceed the amount allowable as a deduction under §213 to the employee for amounts paid during the taxable year for medical care (determined without regard to whether the employee itemizes deductions for such taxable year).

72(t)(2)(C) PAYMENTS TO ALTERNATE PAYEES PURSUANT TO QUALIFIED DOMESTIC RELATIONS ORDERS.--Any distribution to an alternate payee pursuant to a qualified domestic relations order (within the meaning of §414(p)(1)).

72(t)(2)(D) DISTRIBUTIONS TO UNEMPLOYED INDIVIDUALS FOR HEALTH INSURANCE PREMIUMS.--

72(t)(2)(D)(i) IN GENERAL.--Distributions from an individual retirement plan to an individual after separation from employment--

72(t)(2)(D)(i)(I) if such individual has received unemployment compensation for 12 consecutive weeks under any Federal or State unemployment compensation law by reason of such separation,

72(t)(2)(D)(i)(II) if such distributions are made during any taxable year during which such unemployment compensation is paid or the succeeding taxable year, and

72(t)(2)(D)(i)(III) to the extent such distributions do not exceed the amount paid during the taxable year for insurance described in §213(d)(1)(D) with respect to the individual and the individual's spouse and dependents (as defined in §152).

72(t)(2)(D)(ii) DISTRIBUTIONS AFTER REEMPLOYMENT.--Clause (i) shall not apply to any distribution made after the individual has been employed for at least 60 days after the separation from employment to which clause (i) applies.

72(t)(2)(D)(iii) SELF-EMPLOYED INDIVIDUALS.--To the extent provided in regulations, a self-employed individual shall be treated as meeting the requirements of clause (i)(I) if, under Federal or State law, the individual would have received unemployment compensation but for the fact the individual was self-employed.

72(t)(2)(E) DISTRIBUTIONS FROM INDIVIDUAL RETIREMENT PLANS FOR HIGHER EDUCATION

EXPENSES.--Distributions to an individual from an individual retirement plan to the extent such distributions do not exceed the qualified higher education expenses (as defined in paragraph (7)) of the taxpayer for the taxable year. Distributions shall not be taken into account under the preceding sentence if such distributions are described in subparagraph (A), (C), or (D) or to the extent paragraph (1) does not apply to such distributions by reason of subparagraph (B).

72(t)(2)(F) DISTRIBUTIONS FROM CERTAIN PLANS FOR FIRST HOME PURCHASES.--Distributions to an individual from an individual retirement plan which are qualified first-time homebuyer distributions (as defined in paragraph (8)). Distributions shall not be taken into account under the preceding sentence if such distributions are described in subparagraph (A), (C), (D), or (E) or to the extent paragraph (1) does not apply to such distributions by reason of subparagraph (B).

72(t)(3) LIMITATIONS.--

72(t)(3)(A) CERTAIN EXCEPTIONS NOT TO APPLY TO INDIVIDUAL RETIREMENT PLANS.--Subparagraphs (A)(v) and (C) of paragraph (2) shall not apply to distributions from an individual retirement plan.

72(t)(3)(B) PERIODIC PAYMENTS UNDER QUALIFIED PLANS MUST BEGIN AFTER SEPARATION.--Paragraph (2)(A)(iv) shall not apply to any amount paid from a trust described in § 401(a) which is exempt from tax under § 501(a) or from a contract described in § 72(e)(5)(D)(ii) unless the series of payments begins after the employee separates from service.

72(t)(4) CHANGE IN SUBSTANTIALLY EQUAL PAYMENTS.--

72(t)(4)(A) IN GENERAL.--If--

72(t)(4)(A)(i) paragraph (1) does not apply to a distribution by reason of paragraph (2)(A)(iv), and

72(t)(4)(A)(ii) the series of payments under such paragraph are subsequently modified (other than by reason of death or disability)--

72(t)(4)(A)(ii)(I) before the close of the 5-year period beginning with the date of the first payment and after the employee attains age 59 1/2, or

72(t)(4)(A)(ii)(II) before the employee attains age 59 1/2,

the taxpayer's tax for the 1st taxable year in which such modification occurs shall be increased by an amount, determined under regulations, equal to the tax which (but for paragraph (2)(A)(iv)) would have been imposed, plus interest for the deferral period.

72(t)(4)(B) DEFERRAL PERIOD.--For purposes of this paragraph, the term "deferral period" means the period beginning with the taxable year in which (without regard to paragraph (2)(A)(iv)) the distribution would have been includible in gross income and ending with the taxable year in which the modification described in subparagraph (A) occurs.

72(t)(5) EMPLOYEE.--For purposes of this subsection, the term "employee" includes any participant, and in the case of an individual retirement plan, the individual for whose benefit such plan was established.

72(t)(6) SPECIAL RULES FOR SIMPLE RETIREMENT ACCOUNTS.--In the case of any amount received from a simple retirement account (within the meaning of § 408(p)) during the 2-year period beginning on the date such individual first participated in any qualified salary reduction arrangement maintained by the individual's employer under § 408(p)(2) , paragraph (1) shall be applied by substituting "25 percent" for "10 percent".

72(t)(7) QUALIFIED HIGHER EDUCATION EXPENSES.--For purposes of paragraph (2)(E)--

72(t)(7)(A) IN GENERAL.--The term "qualified higher education expenses" means qualified higher education expenses (as defined in §529(e)(3)) for education furnished to--

72(t)(7)(A)(i) the taxpayer,

72(t)(7)(A)(ii) the taxpayer's spouse, or

72(t)(7)(A)(iii) any child (as defined in §151(c)(3)) or grandchild of the taxpayer or the taxpayer's spouse, at an eligible educational institution (as defined in §529(e)(5)).

72(t)(7)(B) COORDINATION WITH OTHER BENEFITS.--The amount of qualified higher education expenses for any taxable

year shall be reduced as provided in § 25A(g)(2) .

72(t)(8) QUALIFIED FIRST-TIME HOMEBUYER DISTRIBUTIONS.--For purposes of paragraph (2)(F)--

72(t)(8)(A) IN GENERAL.--The term "qualified first-time homebuyer distribution" means any payment or distribution received by an individual to the extent such payment or distribution is used by the individual before the close of the 120th day after the day on which such payment or distribution is received to pay qualified acquisition costs with respect to a principal residence of a first-time homebuyer who is such individual, the spouse of such individual, or any child, grandchild, or ancestor of such individual or the individual's spouse.

72(t)(8)(B) LIFETIME DOLLAR LIMITATION.--The aggregate amount of payments or distributions received by an individual which may be treated as qualified first-time homebuyer distributions for any taxable year shall not exceed the excess (if any) of--

72(t)(8)(B)(i) \$10,000, over

72(t)(8)(B)(ii) the aggregate amounts treated as qualified first-time homebuyer distributions with respect to such individual for all prior taxable years.

72(t)(8)(C) QUALIFIED ACQUISITION COSTS.--For purposes of this paragraph, the term "qualified acquisition costs" means the costs of acquiring, constructing, or reconstructing a residence. Such term includes any usual or reasonable settlement, financing, or other closing costs.

72(t)(8)(D) FIRST-TIME HOMEBUYER; OTHER DEFINITIONS.--For purposes of this paragraph--

72(t)(8)(D)(i) FIRST-TIME HOMEBUYER.--The term "first-time homebuyer" means any individual if--

72(t)(8)(D)(i)(I) such individual (and if married, such individual's spouse) had no present ownership interest in a principal residence during the 2-year period ending on the date of acquisition of the principal residence to which this paragraph applies, and

72(t)(8)(D)(i)(II) subsection (h) or (k) of §1034 (as in effect on the day before the date of the enactment of this paragraph) did not suspend the running of any period of time specified in §1034 (as so in effect) with respect to such individual on the day before the date the distribution is applied pursuant to subparagraph (A).

72(t)(8)(D)(ii) PRINCIPAL RESIDENCE.--The term "principal residence" has the same meaning as when used in §121 .

72(t)(8)(D)(iii) DATE OF ACQUISITION.--The term "date of acquisition" means the date--

72(t)(8)(D)(iii)(I) on which a binding contract to acquire the principal residence to which subparagraph (A) applies is entered into, or

72(t)(8)(D)(iii)(II) on which construction or reconstruction of such a principal residence is commenced.

72(t)(8)(E) SPECIAL RULE WHERE DELAY IN ACQUISITION.--If any distribution from any individual retirement plan fails to meet the requirements of subparagraph (A) solely by reason of a delay or cancellation of the purchase or construction of the residence, the amount of the distribution may be contributed to an individual retirement plan as provided in §408(d)(3)(A)(i) (determined by substituting "120th day" for "60th day" in such section), except that--

72(t)(8)(E)(i) §408(d)(3)(B) shall not be applied to such contribution, and

72(t)(8)(E)(ii) such amount shall not be taken into account in determining whether §408(d)(3)(B) applies to any other amount.

APPENDIX B: IRC Reg. §1.72-17A(f) Regulations On Determining Disability

(f) *Meaning of disabled.*--(1) Section 72(m)(7) provides that an individual shall be considered to be disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration. In determining whether an individual's impairment makes him unable to engage in any substantial gainful activity, primary consideration shall be given to the nature and severity of his impairment. Consideration shall also be given to other factors such as the individual's education, training, and work experience. The substantial gainful activity to which section 72(m)(7) refers is the activity, or a comparable activity, in which the individual customarily engaged prior to the arising of the disability or prior to retirement if the individual was retired at the time the disability arose.

(2) Whether or not the impairment in a particular case constitutes a disability is to be determined with reference to all the facts in the case. The following are examples of impairments which would ordinarily be considered as preventing substantial gainful activity:

- (i) Loss of use of two limbs;
- (ii) Certain progressive diseases which have resulted in the physical loss or atrophy of a limb, such as diabetes, multiple sclerosis, or Buerger's disease;
- (iii) Diseases of the heart, lungs, or blood vessels which have resulted in major loss of heart or lung reserve as evidenced by X-ray, electrocardiogram, or other objective findings, so that despite medical treatment breathlessness, pain, or fatigue is produced on slight exertion, such as walking several blocks, using public transportation, or doing small chores;
- (iv) Cancer which is inoperable and progressive;
- (v) Damage to the brain or brain abnormality which has resulted in severe loss of judgment, intellect, orientation, or memory;
- (vi) Mental diseases (e.g., psychosis or severe psychoneurosis) requiring continued institutionalization or constant supervision of the individual;
- (vii) Loss or diminution of vision to the extent that the affected individual has a central visual acuity of no better than 20/200 in the better eye after best correction, or has a limitation in the fields of vision such that the widest diameter of the visual fields subtends an angle no greater than 20 degrees;
- (viii) Permanent and total loss of speech;
- (ix) Total deafness uncorrectible by a hearing aid.

The existence of one or more of the impairments described in this subparagraph (or of an impairment of greater severity) will not, however, in and of itself always permit a finding that an individual is disabled as defined in section 72(m)(7). Any impairment, whether of lesser or greater severity, must be evaluated in terms of whether it does in fact prevent the individual from engaging in his customary or any comparable substantial gainful activity.

(3) In order to meet the requirements of section 72(m)(7), an impairment must be expected either to continue for a long and indefinite period or to result in death. Ordinarily, a terminal illness because of disease or injury would result in disability. The term "indefinite" is used in the sense that it cannot reasonably be anticipated that the impairment will, in the foreseeable future, be so diminished as no longer to prevent substantial gainful activity. For example, an individual who suffers a bone fracture which prevents him from working for an extended period of time will not be considered disabled, if his recovery can be expected in the foreseeable future; if the fracture persistently fails to knit, the individual would ordinarily be considered disabled.

(4) An impairment which is remediable does not constitute a disability within the meaning of section 72(m)(7). An individual will not be deemed disabled if, with reasonable effort and safety to himself, the impairment can be diminished to the extent that the individual will not be prevented by the impairment from engaging in his customary or any comparable substantial gainful activity. [Reg. §1.72-17A.]

APPENDIX C-1: IRS PRESS RELEASE - OCTOBER 3, 2002 REGARDING THE ISSUANCE OF REVENUE RULING 2002-62

FROM THE OFFICE OF PUBLIC AFFAIRS

October 3, 2002
PO-3498

TREASURY HELPS TAXPAYERS PRESERVE RETIREMENT SAVINGS BY ALLOWING A CHANGE TO PENSION DISTRIBUTION AMOUNTS

Today the Treasury Department and the Internal Revenue Service released Revenue Ruling 2002-62 that will help taxpayers preserve their retirement savings when there is an unexpected drop in the value of their retirement savings. Some taxpayers began receiving fixed payments from their IRA or retirement plan based on the value of their account at the time they started receiving payments. Those taxpayers may now switch – without penalty -- to a method of determining the amount of their payments based on the value of their account as it changes from year to year.

“Taxpayers have worked hard to build their retirement savings. They shouldn’t be penalized when the market is down,” stated Pam Olson, Assistant Secretary for Tax Policy. “This change will help many taxpayers to preserve their retirement savings by allowing those individuals to slow their distributions down in the event of unexpected market downturns.”

Generally, taxpayers are subject to an extra 10% tax (in addition to regular income tax) on amounts withdrawn from their IRAs or employer-sponsored individual account plans prior to reaching 59½. An exception to that tax is when a taxpayer takes distributions as part of a series of substantially equal periodic payments over the taxpayer’s life expectancy or the joint life expectancies of taxpayer and beneficiary. The IRS issued guidance in 1989 (Q&A 12 of Notice 89-25) that provided three methods for satisfying the “substantially equal periodic payment” exception.

Two of the safe-harbor methods described in Notice 89-25 result in a fixed amount that is required to be distributed and could result in the premature depletion of the taxpayer’s account in the event that the value of the assets in the account suffers a decline in market value. Revenue Ruling 2002-62 provides relief to taxpayers who selected one of these two methods by permitting them to change from a method for determining the payments under which the amount is fixed to the third method under the safe-harbor where the amount changes from year to year based on the value in the account from which the distributions are being made.

In addition to permitting a one-time switch in method, the revenue ruling:

- Clarifies how an individual can satisfy the permitted method that tracks the required minimum distribution rules of section 401(a)(9) in light of the recent finalization of regulations regarding those requirements;
- Provides guidance on what constitutes a reasonable rate of interest for determining payments to satisfy the substantially equal periodic payment rule; and
- Provides a choice of mortality tables that can be used in satisfying the permitted methods.

Part I

Section 72.--Annuities; Certain Proceeds of Endowment and Life Insurance Contracts
Rev. Rul. 2002-62

SECTION 1. PURPOSE AND BACKGROUND

.01 *The purpose* of this revenue ruling is to modify the provisions of Q&A-12 of Notice 89-25, 1989-1 C.B. 662, which provides guidance on what constitutes a series of substantially equal periodic payments within the meaning of 72(t)(2)(A)(iv) of the Internal Revenue Code from an individual account under a qualified retirement plan. Section 72(t) provides for an additional income tax on early withdrawals from qualified retirement plans (as defined in 4974(c)). Section 4974(c) provides, in part, that the term "qualified retirement plan" means (1) a plan described in 401 (including a trust exempt from tax under 501(a)), (2) an annuity plan described in 403(a), (3) a tax-sheltered annuity arrangement described in 403(b), (4) an individual retirement account described in 408(a), or (5) an individual retirement annuity described in 408(b).

.02 (a) *Section 72(t)(1)* provides that if an employee or IRA owner receives any amount from a qualified retirement plan before attaining age 59 1/2, the employee's or IRA owner's income tax is increased by an amount equal to 10-percent of the amount that is includible in the gross income unless one of the exceptions in 72(t)(2) applies.

(b) *Section 72(t)(2)(A)(iv)* provides, in part, that if distributions are part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancy) of the employee and beneficiary, the tax described in 72(t)(1) will not be applicable. Pursuant to 72(t)(5), in the case of distributions from an IRA, the IRA owner is substituted for the employee for purposes of applying this exception.

(c) *Section 72(t)(4)* provides that if the series of substantially equal periodic payments that is otherwise excepted from the 10-percent tax is subsequently modified (other than by reason of death or disability) within a 5-year period beginning on the date of the first payment, or, if later, age 59 1/2, the exception to the 10-percent tax does not apply, and the taxpayer's tax for the year of modification shall be increased by an amount which, but for the exception, would have been imposed, plus interest for the deferral period.

(d) *Q&A-12 of Notice 89-25* sets forth three methods for determining whether payments to individuals from their IRAs or, if they have separated from service, from their qualified retirement plans constitute a series of substantially equal periodic payments for purposes of 72(t)(2)(A)(iv).

(e) *Final Income Tax Regulations* that were published in the April 17, 2002, issue of the Federal Register under 401(a)(9) provide new life expectancy tables for determining required minimum distributions.

SECTION 2. METHODS

.01 *General rule.* Payments are considered to be substantially equal periodic payments within the meaning of 72(t)(2)(A)(iv) if they are made in accordance with one of the three calculations described in paragraphs (a) - (c) of this subsection (which is comprised of the three methods described in Q&A-12 of Notice 89-25).

(a) *The required minimum distribution 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. If this method is chosen, there will not be deemed to be a modification in the series of substantially equal periodic payments, even if the amount of payments changes from year to year, provided there is not a change to another method of determining the payments.

(b) *The fixed 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. Under this method, the account balance, the number from the chosen life expectancy table and the resulting annual payment are determined once for the first distribution year and the annual payment is the same amount in each succeeding year.

(c) *The fixed 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. Under this method, the account balance, the annuity factor, the chosen interest rate and the resulting annual payment are determined once for the first distribution year and the annual payment is the same amount in each succeeding year.

.02 *Other rules.* The following rules apply for purposes of this section.

(a) *Life expectancy tables.* The life expectancy tables that can be used to determine distribution periods are: (1) the uniform lifetime table in Appendix A, or (2) the single life expectancy table in 1.401(a)(9)-9, Q&A-1 of the Income Tax Regulations or (3) the joint and last survivor table in 1.401(a)(9)-9, Q&A-3. The number that is used for a distribution year is the number shown from the table for the employee's (or IRA owner's) age on his or her birthday in that year. If the joint and survivor table is being used, the age of the beneficiary on the beneficiary's birthday in the year is also used. In the case of the required minimum distribution method, the same life expectancy table that is used for the first distribution year must be used in each following year. Thus, if the taxpayer uses the single life expectancy table for the required minimum distribution method in the first distribution year, the same table must be used in subsequent distribution years.

(b) *Beneficiary under joint tables.* If the joint life and last survivor table in 1.401(a)(9)-9, Q&A-3, is used, the survivor must be the actual beneficiary of the employee with respect to the account for the year of the distribution. If there is more than one beneficiary, the identity and age of the beneficiary used for purposes of each of the methods described in section 2.01 are determined under the rules for determining the designated beneficiary for purposes of 401(a)(9). The beneficiary is determined for a year as of January 1 of the year, without regard to changes in the beneficiary in that year or beneficiary determinations in prior years. For example, if a taxpayer starts distributions from an IRA in 2003 at age 50 and a 25-year-old and 55-year-old are beneficiaries on January 1, the 55-year-old is the designated beneficiary and the number for the taxpayer from the joint and last survivor tables (age 50 and age 55) would be 38.3, even though later in 2003 the 55-year-old is eliminated as a beneficiary. However, if that beneficiary is eliminated or dies in 2003, under the required minimum distribution method, that individual would not be taken into account in future years. If, in any year there is no beneficiary, the single life expectancy table is used for that year.

(c) *Interest rates.* 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 revenue rulings that contain the 1274(d) federal mid-term rates may be found at www.irs.gov/tax_regs/fedrates.html.

(d) *Account balance.* The account balance that is used to determine payments must be determined in a reasonable manner based on the facts and circumstances. For example, for an IRA with daily valuations that made its first distribution on July 15, 2003, 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. For subsequent years, under the required minimum distribution method, it would be reasonable to use the value either on the December 31 of the prior year or on a date within a reasonable period before that year's distribution.

(e) *Changes to account balance.* Under all three methods, substantially equal periodic payments are calculated with respect to an account balance as of the first valuation date selected in paragraph (d) above. Thus, a modification to the series of payments will occur if, after such date, there is (i) any addition to the account balance other than gains or losses, (ii) any nontaxable transfer of a portion of the account balance to another retirement plan, or (iii) a rollover by the taxpayer of the amount received resulting in such amount not being taxable.

.03 *Special rules.* The special rules described below may be applicable.

(a) *Complete depletion of assets.* If, as a result of following an acceptable method of determining substantially equal periodic payments, an individual's assets in an individual account plan or an IRA are exhausted, the individual will not be subject to additional income tax under 72(t)(1) as a result of not receiving substantially equal periodic payments and the resulting cessation of payments will not be treated as a modification of the series of payments.

(b) *One-time change to required minimum distribution method.* An individual who begins distributions in a year using either the fixed amortization method or the fixed annuitization method may in any subsequent year switch to the required minimum distribution method to determine the payment for the year of the switch and all subsequent years and the change in method will not be treated as a modification within the meaning of 72(t)(4). Once a change is made under this paragraph, the required minimum distribution method must be followed in all subsequent years. Any subsequent change will be a modification for purposes of 72(t)(4).

SECTION 3. EFFECTIVE DATE AND TRANSITIONAL RULES

The guidance in this revenue ruling replaces the guidance in Q&A-12 of Notice 89-25 for any series of payments commencing on or after January 1, 2003, and may be used for distributions commencing in 2002. If a series of payments commenced in a year prior

to 2003 that satisfied 72(t)(2)(A)(iv), the method of calculating the payments in the series is permitted to be changed at any time to the required minimum distribution method described in section 2.01(a) of this guidance, including use of a different life expectancy table.

SECTION 4. EFFECT ON OTHER DOCUMENTS

Q&A-12 of Notice 89-25 is modified.

SECTION 5. REQUEST FOR COMMENTS

The Service and Treasury invite comments with respect to the guidance provided in this revenue ruling. Comments should reference Rev. Rul. 2002-62. Comments may be submitted to CC:ITA:RU (Rev. Rul. 2002-62, room 5226, Internal Revenue Service, POB 7604 Ben Franklin Station, Washington, DC 20044. Comments may be hand delivered between the hours of 8:30 a.m. and 5 p.m. Monday to Friday to: CC:ITA:RU (Rev. Rul. 2002-62), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, D.C. Alternatively, comments may be submitted via the Internet at Notice.Comments@irs.counsel.treas.gov. All comments will be available for public inspection and copying.

Drafting Information

The principal author of this revenue ruling is Michael Rubin of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this revenue ruling, please contact Mr. Rubin at 1-202-283-9888 (not a toll-free number).

Authors Note: Following the actual ruling as published by the IRS are two appendices; Appendix A - Uniform Life table which is reproduced in full as Appendix F following; Appendix B - Mortality Table Used to Formulate the Single Life table in § 1.401(a)(9)-9, Q&A-1 which is reproduced in full as Appendix H following.

APPENDIX C-3: IRS FREQUENTLY ASKED QUESTIONS (FAQs)

FAQs regarding Revenue Ruling 2002-62

These frequently asked questions and answers are provided for general information only and should not be cited as any type of legal authority. They are designed to provide the user with information required to respond to general inquiries. Due to the uniqueness and complexities of Federal tax law, it is imperative to ensure a full understanding of the specific question presented, and to perform the requisite research to ensure a correct response is provided.

- (1) What is the additional income tax under section 72(t)(1) of the Internal Revenue Code?
- (2) What is the exception in section 72(t)(2)(A)(iv)?
- (3) Has the Service issued guidance on this exception?
- (4) Are there new rules that may be used for calculating substantially equal periodic payments under section 72(t)(2)(A)(iv)?
- (5) Generally, when are these rules effective?
- (6) What are the components of the required minimum distribution method?
- (7) What are the components of the fixed amortization method?
- (8) What are the components of the fixed annuitization method?
- (9) If an individual began receiving substantially equal periodic payments before calendar 2003 using one of the three methods in Notice 89-25, may that individual continue with that method on or after January 1, 2003?
- (10) If an individual begins receiving substantially equal periodic payments using a fixed method on or after January 1, 2003, may that individual change to the required minimum distribution method?
- (11) How are interest rates determined?
- (12) How is life expectancy determined?
- (13) How is the account balance determined?
- (14) How are annual, substantially equal periodic payments determined for purposes of the required minimum distribution method, the fixed amortization method and the fixed annuity method?
- (15) What is an example of a one-time change from a fixed amortization method to the required minimum distribution method?
- (16) What is the effect of an account being completely depleted?
- (17) Are the methods contained in Rev. Rul. 2002-62 the only acceptable methods of meeting section 72(t)(2)(A)(iv) of the Code?

(1) *What is the additional income tax under section 72(t)(1) of the Internal Revenue Code?*

Section 72(t)(1) provides that an additional tax of 10 percent will be imposed on the amount includible in income with respect to a distribution from a qualified retirement plan as defined in section 4974(c). Various exceptions to this tax are set forth in section 72(t)(2).

(2) *What is the exception in section 72(t)(2)(A)(iv)?*

Section 72(t)(2)(A)(iv) provides, in part, that if distributions are part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancy) of the employee and beneficiary, the tax described in section 72(t)(1) will not be applicable. Pursuant to section 72(t)(5), in the case of distributions from an IRA, the IRA owner is substituted for the employee for purposes of applying this exception. Section 72(t)(4) provides that if the series of substantially equal periodic payments that is otherwise excepted from the 10-percent tax is subsequently modified (other than by reason of death or disability) within a 5-year period beginning on the date of the first payment, or, if later, age 59½, the exception to the 10-percent tax does not apply, and the taxpayer's tax for the year of modification shall be increased by an amount which, but for the exception, would have been imposed, plus interest for the deferral period.

(3) *Has the Service issued guidance on this exception?*

Yes. In Q&A-12 of Notice 89-25, 1989-2 C.B. 662, the Service published guidance with respect to certain types of plans. In particular, Q&A-12 of Notice 89-25 pertains to individual account plans (including tax-sheltered annuities under section 403(b)) and individual

retirement arrangements (both individual retirement accounts and individual retirement annuities). Q&A-12 of Notice 89-25 sets forth three methods that may be used in determining what are substantially equal periodic payments for purposes of section 72(t)(2)(A)(iv) of the Code. These are (1) a variable method, which is the required minimum distribution method, (2) a fixed amortization method, and (3) a fixed annuity method.

(4) *Are there new rules that may be used for calculating substantially equal periodic payments under section 72(t)(2)(A)(iv)?*

Yes. These new rules can be found in Rev. Rul. 2002-62, 2002-42 I.R.B. 710, which was made public on October 3, 2002, before its publication in issue 2002-42 of the Internal Revenue Bulletin on October 21, 2002. Rev. Rul. 2002-62 consolidates the descriptions of the methods in one place and describes the components of the various methods.

(5) *Generally, when are these rules effective?*

The rules are effective for all payments commencing on or after January 1, 2003. However, see Q&A-9 for a transitional rule.

(6) *What are the components of the required minimum distribution method?*

The required minimum distribution method consists of an account balance and a life expectancy (single life or uniform life or joint life and last survivor each using the age(s) attained in the year for which distributions are calculated). The annual payment is redetermined for each year.

(7) *What are the components of the fixed amortization method?*

The fixed amortization method consists of an account balance amortized over a specified number of years equal to life expectancy (single life or uniform life or joint life and last survivor) and a rate of interest that is not more than 120 percent of the federal mid-term rate published in revenue rulings by the Service. Once an annual distribution amount is calculated under this fixed method, the same dollar amount must be distributed under this method in subsequent years.

(8) *What are the components of the fixed annuitization method?*

The fixed annuitization method consists of an account balance, an annuity factor, and an annual payment. The age annuity factor is calculated based on the mortality table in Appendix B of Rev. Rul. 2002-62 and a rate of interest that is not more than 120 percent of the federal mid-term rate published in revenue rulings by the Service. Once an annual distribution amount is calculated under this fixed method, the same dollar amount must be distributed under this method in subsequent years.

(9) *If an individual began receiving substantially equal periodic payments before calendar 2003 using one of the three methods in Notice 89-25, may that individual continue with that method on or after January 1, 2003?*

Yes. For example, if a 50-year-old individual began receiving substantially equal periodic payments in 1999 using the fixed amortization method, the fixed stream of periodic payments may continue under that method.

(10) *If an individual begins receiving substantially equal periodic payments using a fixed method on or after January 1, 2003, may that individual change to the required minimum distribution method?*

Yes. If an individual begins receiving payments under either the fixed amortization method or the fixed annuitization method, that individual may change to the required minimum distribution method in a subsequent year. However, under Rev. Rul. 2002-62 once a change is made that change must be followed in all subsequent years.

(11) *How are interest rates determined?*

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 section 1274(d) of the Code for either of the two months immediately preceding the month in which the distribution begins). These interest rates are published by the Service in revenue rulings; they are cumulatively available within the Index of Applicable Federal Rates.

(12) *How is life expectancy determined?*

The life expectancy tables that can be used are (1) the uniform life table in Appendix A of Rev. Rul. 2002-62, (2) the single life expectancy table in § 1.401(a)(9)-9, Q&A-1 of the Income Tax Regulations or (3) the joint life and last survivor table in § 1.401(a)(9)-9, Q&A-3 of

the regulations.

(13) How is the account balance determined?

The account balance may be determined in any reasonable manner that is used consistently.

(14) How are annual, substantially equal periodic payments determined for purposes of the required minimum distribution method, the fixed amortization method and the fixed annuity method?

An example of the required distribution method, an example of the fixed amortization method and an example of the fixed annuity method using the methodologies described in Rev. Rul. 2002-62 are set forth.

Facts: Mr. B is the owner of an IRA from which he would like to start taking distributions beginning in 2003. Mr. B will celebrate his 50th birthday in January 2003. Mr. B would like to avoid the additional 10% tax imposed on early distributions under section 72(t)(1) by taking advantage of the exception in section 72(t)(2)(A)(iv) for distributions in the form of substantially equal periodic payments.

Assumptions: The account balance of Mr. B's IRA is \$400,000 as of December 31, 2002, and this is the account balance (and, when applicable, the date as of which the account balance is determined) used to calculate distributions. 120% of the federal mid-term rate for the appropriate month is assumed to be 4.5% and, when applicable, this is the interest rate that will be used for calculations. Distributions will be over Mr. B's life only and, where applicable, single life expectancy will be used for calculations.

1. Required minimum distribution method

For 2003, the annual distribution amount (\$11,695.91) is calculated by dividing the December 31, 2002, account balance (\$400,000) by the single life expectancy (34.2) obtained from Q&A-1 of § 1.401(a)(9)-9 of the Income Tax Regulations when an age of 50 is used.

$$\$400,000/34.2 = \$11,695.91$$

For subsequent years, the annual distribution amount will be calculated by dividing the account balance as of December 31 of the prior year by the single life expectancy obtained from the same single life expectancy table using the age attained in the year for which distributions are calculated. For example, if Mr. B's IRA account balance, after the 2003 distribution has been paid, is \$408,304 on December 31, 2003, the annual distribution amount for 2004 (\$12,261.38) is calculated by dividing the December 31, 2003 account balance (\$408,304) by the single life expectancy (33.3) obtained from Q&A-1 of § 1.401(a)(9)-9 of the Income Tax Regulations when an age of 51 is used.

$$\$408,304/33.3 = \$12,261.38$$

2. Fixed amortization method

For 2003, the annual distribution amount will be calculated by amortizing the account balance (\$400,000) over a number of years equal to Mr. B's single life expectancy (34.2) (obtained from Q&A-1 of § 1.401(a)(9)-9 of the Income Tax Regulations when an age of 50 is used), at a rate of interest equal to 4.5%. If an end-of-year payment is calculated, then the annual distribution amount in 2003 is \$23,134.27. Once an annual distribution amount is calculated under this fixed method, the same amount will be distributed under this method in subsequent years.

3. Fixed annuitization method

Under this method the annual distribution amount for 2003 is equal to the account balance (\$400,000) divided by the cost of an annuity factor that would provide one dollar per year over Mr. B's life, beginning at age 50 (i.e., the actuarial present value of an annuity of one dollar a year payable for the life of a 50 year old). The age 50 annuity factor (17.462) is calculated based on the mortality table in Appendix B of Rev. Rul. 2002-62 and an interest rate of 4.5%. Such calculations would normally be made by an actuary. The annual distribution amount is calculated as $\$400,000/17.462 = \$22,906.88$. Once an annual distribution amount is calculated under this fixed method, the same amount will be distributed under this method in subsequent years.

(15) What is an example of a one-time change from a fixed amortization method to the required minimum distribution method?

Facts and Assumptions: Mr. S started receiving distributions from his IRA in the form of annual substantially equal periodic payments in 1998 at age 50. His annual payment (\$97,258) had been originally calculated using the amortization methodology, with the same amount distributed each year. Following a steep decline in his IRA account balance from \$1,400,000 in 1998 to \$750,000 in 2002, Mr. S would like to use the special rule allowing a one-time change to the required minimum distribution method provided in section 2.03(b) of Rev. Rul. 2002-62 to determine a new annual distribution amount for 2002. For this one-time change in method, Mr. S will determine an annual distribution amount for 2002 using his IRA account balance on September 30, 2002 (\$750,000), and a single life expectancy of 30.5 (obtained from Q&A-1 of § 1.401(a)(9)-9 of the Income Tax Regulations when an age of 54 is used). Under the new method, the annual distribution amount for 2002 is \$24,590.16 ($\$750,000/30.5$). Mr. S must use the required minimum distribution method to determine the annual distribution amount for subsequent years.

(16) What is the effect of an account being completely depleted?

If an individual's assets in an individual account plan or an IRA are depleted, the individual will not be subject to the income tax of section 72(t)(1) of the Code as a result of not receiving substantially equal periodic payments. In addition, the recapture tax described in section 72(t)(4) of the Code will not be applicable.

(17) Are the methods contained in Rev. Rul. 2002-62 the only acceptable methods of meeting section 72(t)(2)(A)(iv) of the Code?

No. Another method may be used in a private letter ruling request, but, of course, it would be subject to individual analysis.

**APPENDIX D: EXCERPT FROM IRS PUBLICATION 590
(FOR USE IN PREPARING 2002 TAX RETURNS)**

When Can I Withdraw or Use IRA Assets?

Because a traditional IRA is a tax-favored means of saving for your retirement, a 10% additional tax generally applies if you withdraw or use IRA assets before you are age 59 ½. This is explained under *Age 59 ½ rule*.

However, you generally can make a tax-free withdrawal of contributions if you do it before the due date for filing your tax return for the year in which you made them. This means that, even if you are under age 59 ½, the 10% additional tax may not apply. These withdrawals are explained later under *Contributions Returned Before the Due Date*.

Age 59 ½ Rule

Generally, if you are under age 59 ½ you must pay a 10% additional tax on the distribution of any assets (money or other property) from your traditional IRA. Distributions before you are age 59 ½ are called early distributions.

The 10% additional tax applies to the part of the distribution that you have to include in gross income. It is in addition to any regular income tax on that amount. A number of exceptions to this rule are discussed below under exceptions. Also see *Contributions Returned Before*

the Due Date, later, and *Early Distributions* under *What Acts Result in Penalties or Additional Taxes*, later.

You may have to pay a 25%, rather than 10%, additional tax if you receive distributions from a SIMPLE IRA before you are age 59 ½. See Additional Tax on Early Distributions under When Can I Withdraw or Use Assets? in chapter 4.

After age 59½ and before age 70 ½.

After you reach age 59 ½, you can receive distributions from your traditional IRA without having to pay the 10% additional tax. Even though you can receive distributions after you reach age 59 ½ distributions are not required until you reach age 70 ½. See *When Must I Withdraw IRA Assets? (Required Distributions)*, later in this chapter.

Exceptions

There are several exceptions to the age 59 ½ rule. Even if you receive a distribution before you are age 59 ½, you may not have to pay the 10% additional tax if you are in one of the following situations.

- You have unreimbursed medical expenses that are more than 7.5% of your adjusted gross income.
- The distributions are not more than the cost of your medical insurance.
- You are disabled.
- You are the beneficiary of a deceased IRA owner.
- You are receiving distributions in the form of an annuity.
- The distributions are not more than your qualified higher education expenses.
- You use the distributions to buy, build, or rebuild a first home.
- The distribution is due to an IRS levy of the qualified plan.

Most of these exceptions are explained below.

Note. Distributions that are timely and properly rolled over, as discussed earlier, are not subject to either regular income tax or the 10% additional tax. Certain withdrawals of excess contributions after the due date of your return are also tax free and therefore not subject to the 10% additional tax. (See *Excess Contributions Withdrawn After Due Date of Return* under *What Acts Result in Penalties or Additional Taxes*, later.) This also applies to transfers incident to divorce, as discussed earlier under *Can I Move Retirement Plan Assets*.

Unreimbursed medical expenses. Even if you are under age 59 ½ you do not have to pay the 10% additional tax on distributions that are *not* more than:

- 1) The amount you paid for unreimbursed medical expenses during the year of the distribution, minus
- 2) 7.5% of your adjusted gross income (defined later) for the year of the distribution.

You can only take into account unreimbursed medical expenses that you would be able to include in figuring a deduction for medical expenses on Schedule A, Form 1040. You do not have to itemize your deductions to take advantage of this exception to the 10% additional tax.

Adjusted gross income. This is the amount on Form 1040, line 36 or Form 1040A, line 22.

Medical insurance. Even if you are under age 59 ½, you may not have to pay the 10% additional tax on distributions from your traditional IRA during the year that are not more than the amount you paid during the year for medical insurance for yourself, your spouse, and your dependents. You will not have to pay the tax on these amounts if **all four** of the following conditions apply.

- 1) You lost your job.
- 2) You received unemployment compensation paid under any federal or state law for 12 consecutive weeks.
- 3) You receive the distributions during either the year you received the unemployment compensation or the following year.
- 4) You receive the distributions no later than 60 days after you have been reemployed.

Disabled. If you become disabled before you reach age 59 ½, any distributions from your traditional IRA because of your disability are not subject to the 10% additional tax. You are considered disabled if you can furnish proof that you cannot do any substantial gainful activity because of your physical or mental condition. A physician must determine that your condition can be expected to result in death or to be of long, continued, and indefinite duration.

Beneficiary. If you die before reaching age 59 ½, the assets in your traditional IRA can be distributed to your beneficiary or to your estate without either having to pay the 10% additional tax. However, if you inherit a traditional IRA from your deceased spouse and elect to treat it as your own (as discussed under *What If I Inherit an IRA*, earlier), any distribution you later receive before you reach age 59 ½ may be subject to the 10% additional tax.

Annuity. You can receive distributions from your traditional IRA that are part of a series of substantially equal payments over your life (or your life expectancy), or over the lives (or the joint life expectancies) of you and your beneficiary, without having to pay the 10% additional tax, even if you receive such distributions before you are age 59 ½. You must use an IRS approved distribution method and you must take at least one distribution annually for this exception to apply. The “required minimum distribution method,” when used for this purpose, results in the exact amount required to be distributed, not the minimum amount. There are two other IRS approved distribution methods that you can use. They are generally referred to as the “fixed amortization method” and the “fixed annuitization method.” These two methods are not discussed in this publication because they are more complex and generally require professional assistance. See Revenue Ruling 2002–62 in *Internal Revenue Bulletin 2002–42* for more information on these two methods. To obtain a copy of this revenue ruling, see *Mail* in chapter 6. This revenue ruling can also be found in many libraries and IRS offices. The payments under this exception must continue for at least 5 years, or until you reach age 59 ½, whichever is the longer period. This 5-year rule does not apply if a change from an approved distribution method is made because of the death or disability of the IRA owner. If the payments under this exception are changed before the end of the above required periods for any reason other than the death or disability of the IRA owner, he or she will be subject to the 10% additional tax. However, if he or she began receiving a series of substantially equal periodic payments before 2003, he or she can change to the required minimum distribution method at any time without incurring the additional tax. Also, for distributions beginning in 2002 and for any series of payments beginning after 2002, if he or she began receiving distributions using either the fixed amortization method or the fixed annuitization method, he or she can make a one-time switch to the required minimum distribution method without incurring the additional tax. For example, if you received a lump-sum distribution of the balance in your traditional IRA before the end of the required period for your annuity distributions and you did not receive it because you were disabled, you would be subject to the 10% additional tax. The tax would apply to the lump-sum distribution and all previous distributions made under the exception rule.

Higher education expenses. Even if you are under age 59 ½, if you paid expenses for higher education during the year, part (or all) of any distribution may not be subject to the 10% additional tax. The part not subject to the tax is generally the amount that is not more than the qualified higher education expenses (defined later) for the year for education furnished at an eligible educational institution (defined later). The education must be for you, your spouse, or the children or grandchildren of you or your spouse. When determining the amount of the distribution that is not subject to the 10% additional tax, **include** qualified higher education expenses paid with any of the following funds.

- An individual’s earnings.
- A loan.
- A gift.
- An inheritance given to either the student or the individual making the withdrawal.
- Personal savings (including savings from a qualified tuition program).

Do not include expenses paid with any of the following funds.

- Tax-free distributions from a Coverdell education savings account (formerly called education IRAs).

- Tax-free scholarships.
- Tax-free employer-provided educational assistance.
- Any tax-free payment (other than a gift, bequest, or devise) due to enrollment at an eligible educational institution.

Qualified higher education expenses. Qualified higher education expenses are tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a student at an eligible educational institution. They also include expenses for special needs services incurred by or for special needs students in connection with their enrollment or attendance. In addition, if the individual is at least a half-time student, room and board are qualified higher education expenses.

Eligible educational institution. This is any college, university, vocational school, or other postsecondary educational institution eligible to participate in the student aid programs administered by the Department of Education. It includes virtually all accredited, public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions. The educational institution should be able to tell you if it is an eligible educational institution.

First home. Even if you are under age 59 ½, you do not have to pay the 10% additional tax on distributions you receive to buy, build, or rebuild a first home. To qualify for treatment as a first-time homebuyer distribution, the distribution must meet *all* the following requirements.

- 1) It must be used to pay qualified acquisition costs (defined later) before the close of the 120th day after the day you received it.
- 2) It must be used to pay qualified acquisition costs for the main home of a first-time homebuyer (defined later) who is any of the following.
 - a) Yourself.
 - b) Your spouse.
 - c) Your or your spouse's child.
 - d) Your or your spouse's grandchild.
 - e) Your or your spouse's parent or other ancestor.
- 3) When added to all your prior qualified first-time homebuyer distributions, if any, the total distributions cannot be more than \$10,000.

If both you and your spouse are first-time homebuyers (defined later), each of you can receive distributions up to \$10,000 for a first home without having to pay the 10% additional tax.

Qualified acquisition costs. Qualified acquisition costs include the following items.

- 1) Costs of buying, building, or rebuilding a home.
- 2) Any usual or reasonable settlement, financing, or other closing costs.

First-time homebuyer. Generally, you are a first-time homebuyer if you had no present interest in a main home during the 2-year period ending on the date of acquisition of the home which the distribution is being used to buy, build, or rebuild. If you are married, your spouse must also meet this no-ownership requirement.

Date of acquisition. The date of acquisition is the date that:

- 1) You enter into a binding contract to buy the main home for which the distribution is being used, or
- 2) The building or rebuilding of the main home for which the distribution is being used begins.

APPENDIX E: SINGLE LIFE EXPECTANCY TABLE From IRC Reg. §1.401(a)(9)-9

Age	Life Exp.	Age	Life Exp.	Age	Life Exp.	Age	Life Exp.
0	82.4	33	50.4	66	20.2	99	3.1
1	81.6	34	49.4	67	19.4	100	2.9
2	80.6	35	48.5	68	18.6	101	2.7
3	79.7	36	47.5	69	17.8	102	2.5
4	78.7	37	46.5	70	17.0	103	2.3
5	77.7	38	45.6	71	16.3	104	2.1
6	76.7	39	44.6	72	15.5	105	1.9
7	75.8	40	43.6	73	14.8	106	1.7
8	74.8	41	42.7	74	14.1	107	1.5
9	73.8	42	41.7	75	13.4	108	1.4
10	72.8	43	40.7	76	12.7	109	1.2
11	71.8	44	39.8	77	12.1	110	1.1
12	70.8	45	38.8	78	11.4	111	1.0
13	69.9	46	37.9	79	10.8		
14	68.9	47	37.0	80	10.2		
15	67.9	48	36.0	81	9.7		
16	66.9	49	35.1	82	9.1		
17	66.0	50	34.2	83	8.6		
18	65.0	51	33.3	84	8.1		
19	64.0	52	32.3	85	7.6		
20	63.0	53	31.4	86	7.1		
21	62.1	54	30.5	87	6.7		
22	61.1	55	29.6	88	6.3		
23	60.1	56	28.7	89	5.9		
24	59.1	57	27.9	90	5.5		
25	58.2	58	27.0	91	5.2		
26	57.2	59	26.1	92	4.9		
27	56.2	60	25.2	93	4.6		
28	55.3	61	24.4	94	4.3		
29	54.3	62	23.5	95	4.1		
30	53.3	63	22.7	96	3.8		
31	52.4	64	21.8	97	3.6		
32	51.4	65	21.0	98	3.4		

APPENDIX F: UNIFORM LIFE EXPECTANCY TABLE

From Revenue Ruling 2002-62: Appendix A

Age	Life Exp.	Age	Life Exp.	Age	Life Exp.	Age	Life Exp.
10	86.2	36	60.4	62	34.9	88	12.7
11	85.2	37	59.4	63	33.9	89	12.0
12	84.2	38	58.4	64	33.0	90	11.4
13	83.2	39	57.4	65	32.0	91	10.8
14	82.2	40	56.4	66	31.1	92	10.2
15	81.2	41	55.4	67	30.2	93	9.6
16	80.2	42	54.4	68	29.2	94	9.1
17	79.2	43	53.4	69	28.3	95	8.6
18	78.2	44	52.4	70	27.4	96	8.1
19	77.3	45	51.5	71	26.5	97	7.6
20	76.3	46	50.5	72	25.6	98	7.1
21	75.3	47	49.5	73	24.7	99	6.7
22	74.3	48	48.5	74	23.8	100	6.3
23	73.3	49	47.5	75	22.9	101	5.9
24	72.3	50	46.5	76	22.0	102	5.5
25	71.3	51	45.5	77	21.2	103	5.2
26	70.3	52	44.6	78	20.3	104	4.9
27	69.3	53	43.6	79	19.5	105	4.5
28	68.3	54	42.6	80	18.7	106	4.2
29	67.3	55	41.6	81	17.9	107	3.9
30	66.3	56	40.7	82	17.1	108	3.7
31	65.3	57	39.7	83	16.3	109	3.4
32	64.3	58	38.7	84	15.5	110	3.1
33	63.3	59	37.8	85	14.8	111	2.9
34	62.3	60	36.8	86	14.1	112	2.6
35	61.4	61	35.8	87	13.4	113	2.4
						114	2.1
						115	1.9

APPENDIX G: JOINT & LAST SURVIVOR LIFE EXPECTANCY TABLE FROM IRC REG. §1.401(a)(9)-9, Q&A-3¹⁹⁴

Ages	30	31	32	33	34	35	36	37	38	39
30	60.2	59.7	59.2	58.8	58.4	58.0	57.6	57.3	57.0	56.7
31	59.7	59.2	58.7	58.2	57.8	57.4	57.0	56.6	56.3	56.0
32	59.2	58.7	58.2	57.7	57.2	56.8	56.4	56.0	55.6	55.3
33	58.8	58.2	57.7	57.2	56.7	56.2	55.8	55.4	55.0	54.7
34	58.4	57.8	57.2	56.7	56.2	55.7	55.3	54.8	54.4	54.0
35	58.0	57.4	56.8	56.2	55.7	55.2	54.7	54.3	53.8	53.4
36	57.6	57.0	56.4	55.8	55.3	54.7	54.2	53.7	53.3	52.8
37	57.3	56.6	56.0	55.4	54.8	54.3	53.7	53.2	52.7	52.3
38	57.0	56.3	55.6	55.0	54.4	53.8	53.3	52.7	52.2	51.7
39	56.7	56.0	55.3	54.7	54.0	53.4	52.8	52.3	51.7	51.2
40	56.4	55.7	55.0	54.3	53.7	53.0	52.4	51.8	51.3	50.8
41	56.1	55.4	54.7	54.0	53.3	52.7	52.0	51.4	50.9	50.3
42	55.9	55.2	54.4	53.7	53.0	52.3	51.7	51.1	50.4	49.9
43	55.7	54.9	54.2	53.4	52.7	52.0	51.3	50.7	50.1	49.5
44	55.5	54.7	53.9	53.2	52.4	51.7	51.0	50.4	49.7	49.1
45	55.3	54.5	53.7	52.9	52.2	51.5	50.7	50.0	49.4	48.7
46	55.1	54.3	53.5	52.7	52.0	51.2	50.5	49.8	49.1	48.4
47	55.0	54.1	53.3	52.5	51.7	51.0	50.2	49.5	48.8	48.1
48	54.8	54.0	53.2	52.3	51.5	50.8	50.0	49.2	48.5	47.8
49	54.7	53.8	53.0	52.2	51.4	50.6	49.8	49.0	48.2	47.5
50	54.6	53.7	52.9	52.0	51.2	50.4	49.6	48.8	48.0	47.3
51	54.5	53.6	52.7	51.9	51.0	50.2	49.4	48.6	47.8	47.0
52	54.4	53.5	52.6	51.7	50.9	50.0	49.2	48.4	47.6	46.8
53	54.3	53.4	52.5	51.6	50.8	49.9	49.1	48.2	47.4	46.6
54	54.2	53.3	52.4	51.5	50.6	49.8	48.9	48.1	47.2	46.4
55	54.1	53.2	52.3	51.4	50.5	49.7	48.8	47.9	47.1	46.3
56	54.0	53.1	52.2	51.3	50.4	49.5	48.7	47.8	47.0	46.1
57	54.0	53.0	52.1	51.2	50.3	49.4	48.6	47.7	46.8	46.0
58	53.9	53.0	52.1	51.2	50.3	49.4	48.5	47.6	46.7	45.8
59	53.8	52.9	52.0	51.1	50.2	49.3	48.4	47.5	46.6	45.7
60	53.8	52.9	51.9	51.0	50.1	49.2	48.3	47.4	46.5	45.6

¹⁹⁴

We have started the reproduction of the J&S table at age 30. The full table is available at www.irs.gov. Besides, anyone under the age of 30 is certainly too young to be reading this material.

Ages	30	31	32	33	34	35	36	37	38	39
61	53.8	52.8	51.9	51.0	50.0	49.1	48.2	47.3	46.4	45.5
62	53.7	52.8	51.8	50.9	50.0	49.1	48.1	47.2	46.3	45.4
63	53.7	52.7	51.8	50.9	49.9	49.0	48.1	47.2	46.3	45.3
64	53.6	52.7	51.8	50.8	49.9	48.9	48.0	47.1	46.2	45.3
65	53.6	52.7	51.7	50.8	49.8	48.9	48.0	47.0	46.1	45.2
66	53.6	52.6	51.7	50.7	49.8	48.9	47.9	47.0	46.1	45.1
67	53.6	52.6	51.7	50.7	49.8	48.8	47.9	46.9	46.0	45.1
68	53.5	52.6	51.6	50.7	49.7	48.8	47.8	46.9	46.0	45.0
69	53.5	52.6	51.6	50.6	49.7	48.7	47.8	46.9	45.9	45.0
70	53.5	52.5	51.6	50.6	49.7	48.7	47.8	46.8	45.9	44.9
71	53.5	52.5	51.6	50.6	49.6	48.7	47.7	46.8	45.9	44.9
72	53.5	52.5	51.5	50.6	49.6	48.7	47.7	46.8	45.8	44.9
73	53.4	52.5	51.5	50.6	49.6	48.6	47.7	46.7	45.8	44.8
74	53.4	52.5	51.5	50.5	49.6	48.6	47.7	46.7	45.8	44.8
75	53.4	52.5	51.5	50.5	49.6	48.6	47.7	46.7	45.7	44.8
76	53.4	52.4	51.5	50.5	49.6	48.6	47.6	46.7	45.7	44.8
77	53.4	52.4	51.5	50.5	49.5	48.6	47.6	46.7	45.7	44.8
78	53.4	52.4	51.5	50.5	49.5	48.6	47.6	46.6	45.7	44.7
79	53.4	52.4	51.5	50.5	49.5	48.6	47.6	46.6	45.7	44.7
80	53.4	52.4	51.4	50.5	49.5	48.5	47.6	46.6	45.7	44.7
81	53.4	52.4	51.4	50.5	49.5	48.5	47.6	46.6	45.7	44.7
82	53.4	52.4	51.4	50.5	49.5	48.5	47.6	46.6	45.6	44.7
83	53.4	52.4	51.4	50.5	49.5	48.5	47.6	46.6	45.6	44.7
84	53.4	52.4	51.4	50.5	49.5	48.5	47.6	46.6	45.6	44.7
85	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.6	45.6	44.7
86	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.6	45.6	44.6
87	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.6	45.6	44.6
88	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.6	45.6	44.6
89	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.6	45.6	44.6
90	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.6	45.6	44.6

Ages	30	31	32	33	34	35	36	37	38	39
91	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.6	45.6	44.6
92	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.6	45.6	44.6
93	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.6	45.6	44.6
94	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.6	45.6	44.6
95	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.5	45.6	44.6
96	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.5	45.6	44.6
97	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.5	45.6	44.6
98	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.5	45.6	44.6
99	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.5	45.6	44.6
100	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.5	45.6	44.6
101	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.5	45.6	44.6
102	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.5	45.6	44.6
103	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.5	45.6	44.6
104	53.3	52.4	51.4	50.4	49.5	48.5	47.5	46.5	45.6	44.6
105	53.3	52.4	51.4	50.4	49.4	48.5	47.5	46.5	45.6	44.6
106	53.3	52.4	51.4	50.4	49.4	48.5	47.5	46.5	45.6	44.6
107	53.3	52.4	51.4	50.4	49.4	48.5	47.5	46.5	45.6	44.6
108	53.3	52.4	51.4	50.4	49.4	48.5	47.5	46.5	45.6	44.6
109	53.3	52.4	51.4	50.4	49.4	48.5	47.5	46.5	45.6	44.6
110	53.3	52.4	51.4	50.4	49.4	48.5	47.5	46.5	45.6	44.6
111	53.3	52.4	51.4	50.4	49.4	48.5	47.5	46.5	45.6	44.6
112	53.3	52.4	51.4	50.4	49.4	48.5	47.5	46.5	45.6	44.6
113	53.3	52.4	51.4	50.4	49.4	48.5	47.5	46.5	45.6	44.6
114	53.3	52.4	51.4	50.4	49.4	48.5	47.5	46.5	45.6	44.6
115	53.3	52.4	51.4	50.4	49.4	48.5	47.5	46.5	45.6	44.6

Ages	40	41	42	43	44	45	46	47	48	49
40	50.2	49.8	49.3	48.9	48.5	48.1	47.7	47.4	47.1	46.8
41	49.8	49.3	48.8	48.3	47.9	47.5	47.1	46.7	46.4	46.1
42	49.3	48.8	48.3	47.8	47.3	46.9	46.5	46.1	45.8	45.4
43	48.9	48.3	47.8	47.3	46.8	46.3	45.9	45.5	45.1	44.8
44	48.5	47.9	47.3	46.8	46.3	45.8	45.4	44.9	44.5	44.2
45	48.1	47.5	46.9	46.3	45.8	45.3	44.8	44.4	44.0	43.6
46	47.7	47.1	46.5	45.9	45.4	44.8	44.3	43.9	43.4	43.0
47	47.4	46.7	46.1	45.5	44.9	44.4	43.9	43.4	42.9	42.4
48	47.1	46.4	45.8	45.1	44.5	44.0	43.4	42.9	42.4	41.9
49	46.8	46.1	45.4	44.8	44.2	43.6	43.0	42.4	41.9	41.4
50	46.5	45.8	45.1	44.4	43.8	43.2	42.6	42.0	41.5	40.9
51	46.3	45.5	44.8	44.1	43.5	42.8	42.2	41.6	41.0	40.5
52	46.0	45.3	44.6	43.8	43.2	42.5	41.8	41.2	40.6	40.1
53	45.8	45.1	44.3	43.6	42.9	42.2	41.5	40.9	40.3	39.7
54	45.6	44.8	44.1	43.3	42.6	41.9	41.2	40.5	39.9	39.3
55	45.5	44.7	43.9	43.1	42.4	41.6	40.9	40.2	39.6	38.9
56	45.3	44.5	43.7	42.9	42.1	41.4	40.7	40.0	39.3	38.6
57	45.1	44.3	43.5	42.7	41.9	41.2	40.4	39.7	39.0	38.3
58	45.0	44.2	43.3	42.5	41.7	40.9	40.2	39.4	38.7	38.0
59	44.9	44.0	43.2	42.4	41.5	40.7	40.0	39.2	38.5	37.8
60	44.7	43.9	43.0	42.2	41.4	40.6	39.8	39.0	38.2	37.5
61	44.6	43.8	42.9	42.1	41.2	40.4	39.6	38.8	38.0	37.3
62	44.5	43.7	42.8	41.9	41.1	40.3	39.4	38.6	37.8	37.1
63	44.5	43.6	42.7	41.8	41.0	40.1	39.3	38.5	37.7	36.9
64	44.4	43.5	42.6	41.7	40.8	40.0	39.2	38.3	37.5	36.7
65	44.3	43.4	42.5	41.6	40.7	39.9	39.0	38.2	37.4	36.6
66	44.2	43.3	42.4	41.5	40.6	39.8	38.9	38.1	37.2	36.4
67	44.2	43.3	42.3	41.4	40.6	39.7	38.8	38.0	37.1	36.3
68	44.1	43.2	42.3	41.4	40.5	39.6	38.7	37.9	37.0	36.2
69	44.1	43.1	42.2	41.3	40.4	39.5	38.6	37.8	36.9	36.0
70	44.0	43.1	42.2	41.3	40.3	39.4	38.6	37.7	36.8	35.9
71	44.0	43.0	42.1	41.2	40.3	39.4	38.5	37.6	36.7	35.9
72	43.9	43.0	42.1	41.1	40.2	39.3	38.4	37.5	36.6	35.8
73	43.9	43.0	42.0	41.1	40.2	39.3	38.4	37.5	36.6	35.7
74	43.9	42.9	42.0	41.1	40.1	39.2	38.3	37.4	36.5	35.6
75	43.8	42.9	42.0	41.0	40.1	39.2	38.3	37.4	36.5	35.6
76	43.8	42.9	41.9	41.0	40.1	39.1	38.2	37.3	36.4	35.5
77	43.8	42.9	41.9	41.0	40.0	39.1	38.2	37.3	36.4	35.5
78	43.8	42.8	41.9	40.9	40.0	39.1	38.2	37.2	36.3	35.4
79	43.8	42.8	41.9	40.9	40.0	39.1	38.1	37.2	36.3	35.4
80	43.7	42.8	41.8	40.9	40.0	39.0	38.1	37.2	36.3	35.4

Ages	40	41	42	43	44	45	46	47	48	49
81	43.7	42.8	41.8	40.9	39.9	39.0	38.1	37.2	36.2	35.3
82	43.7	42.8	41.8	40.9	39.9	39.0	38.1	37.1	36.2	35.3
83	43.7	42.8	41.8	40.9	39.9	39.0	38.0	37.1	36.2	35.3
84	43.7	42.7	41.8	40.8	39.9	39.0	38.0	37.1	36.2	35.3
85	43.7	42.7	41.8	40.8	39.9	38.9	38.0	37.1	36.2	35.2
86	43.7	42.7	41.8	40.8	39.9	38.9	38.0	37.1	36.1	35.2
87	43.7	42.7	41.8	40.8	39.9	38.9	38.0	37.0	36.1	35.2
88	43.7	42.7	41.8	40.8	39.9	38.9	38.0	37.0	36.1	35.2
89	43.7	42.7	41.7	40.8	39.8	38.9	38.0	37.0	36.1	35.2
90	43.7	42.7	41.7	40.8	39.8	38.9	38.0	37.0	36.1	35.2
91	43.7	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.1	35.2
92	43.7	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.1	35.1
93	43.7	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.1	35.1
94	43.7	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.1	35.1
95	43.6	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.1	35.1
96	43.6	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.1	35.1
97	43.6	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.1	35.1
98	43.6	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.0	35.1
99	43.6	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.0	35.1
100	43.6	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.0	35.1
101	43.6	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.0	35.1
102	43.6	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.0	35.1
103	43.6	42.7	41.7	40.8	39.8	38.9	37.9	37.0	36.0	35.1
104	43.6	42.7	41.7	40.8	39.8	38.8	37.9	37.0	36.0	35.1
105	43.6	42.7	41.7	40.8	39.8	38.8	37.9	37.0	36.0	35.1
106	43.6	42.7	41.7	40.8	39.8	38.8	37.9	37.0	36.0	35.1
107	43.6	42.7	41.7	40.8	39.8	38.8	37.9	37.0	36.0	35.1
108	43.6	42.7	41.7	40.8	39.8	38.8	37.9	37.0	36.0	35.1
109	43.6	42.7	41.7	40.7	39.8	38.8	37.9	37.0	36.0	35.1
110	43.6	42.7	41.7	40.7	39.8	38.8	37.9	37.0	36.0	35.1
111	43.6	42.7	41.7	40.7	39.8	38.8	37.9	37.0	36.0	35.1
112	43.6	42.7	41.7	40.7	39.8	38.8	37.9	37.0	36.0	35.1
113	43.6	42.7	41.7	40.7	39.8	38.8	37.9	37.0	36.0	35.1
114	43.6	42.7	41.7	40.7	39.8	38.8	37.9	37.0	36.0	35.1
115	43.6	42.7	41.7	40.7	39.8	38.8	37.9	37.0	36.0	35.1

Ages	50	51	52	53	54	55	56	57	58	59
50	40.4	40.0	39.5	39.1	38.7	38.3	38.0	37.6	37.3	37.1
51	40.0	39.5	39.0	38.5	38.1	37.7	37.4	37.0	36.7	36.4
52	39.5	39.0	38.5	38.0	37.6	37.2	36.8	36.4	36.0	35.7
53	39.1	38.5	38.0	37.5	37.1	36.6	36.2	35.8	35.4	35.1
54	38.7	38.1	37.6	37.1	36.6	36.1	35.7	35.2	34.8	34.5
55	38.3	37.7	37.2	36.6	36.1	35.6	35.1	34.7	34.3	33.9
56	38.0	37.4	36.8	36.2	35.7	35.1	34.7	34.2	33.7	33.3
57	37.6	37.0	36.4	35.8	35.2	34.7	34.2	33.7	33.2	32.8
58	37.3	36.7	36.0	35.4	34.8	34.3	33.7	33.2	32.8	32.3
59	37.1	36.4	35.7	35.1	34.5	33.9	33.3	32.8	32.3	31.8
60	36.8	36.1	35.4	34.8	34.1	33.5	32.9	32.4	31.9	31.3
61	36.6	35.8	35.1	34.5	33.8	33.2	32.6	32.0	31.4	30.9
62	36.3	35.6	34.9	34.2	33.5	32.9	32.2	31.6	31.1	30.5
63	36.1	35.4	34.6	33.9	33.2	32.6	31.9	31.3	30.7	30.1
64	35.9	35.2	34.4	33.7	33.0	32.3	31.6	31.0	30.4	29.8
65	35.8	35.0	34.2	33.5	32.7	32.0	31.4	30.7	30.0	29.4
66	35.6	34.8	34.0	33.3	32.5	31.8	31.1	30.4	29.8	29.1
67	35.5	34.7	33.9	33.1	32.3	31.6	30.9	30.2	29.5	28.8
68	35.3	34.5	33.7	32.9	32.1	31.4	30.7	29.9	29.2	28.6
69	35.2	34.4	33.6	32.8	32.0	31.2	30.5	29.7	29.0	28.3
70	35.1	34.3	33.4	32.6	31.8	31.1	30.3	29.5	28.8	28.1
71	35.0	34.2	33.3	32.5	31.7	30.9	30.1	29.4	28.6	27.9
72	34.9	34.1	33.2	32.4	31.6	30.8	30.0	29.2	28.4	27.7
73	34.8	34.0	33.1	32.3	31.5	30.6	29.8	29.1	28.3	27.5
74	34.8	33.9	33.0	32.2	31.4	30.5	29.7	28.9	28.1	27.4
75	34.7	33.8	33.0	32.1	31.3	30.4	29.6	28.8	28.0	27.2
76	34.6	33.8	32.9	32.0	31.2	30.3	29.5	28.7	27.9	27.1
77	34.6	33.7	32.8	32.0	31.1	30.3	29.4	28.6	27.8	27.0
78	34.5	33.6	32.8	31.9	31.0	30.2	29.3	28.5	27.7	26.9
79	34.5	33.6	32.7	31.8	31.0	30.1	29.3	28.4	27.6	26.8
80	34.5	33.6	32.7	31.8	30.9	30.1	29.2	28.4	27.5	26.7
81	34.4	33.5	32.6	31.8	30.9	30.0	29.2	28.3	27.5	26.6
82	34.4	33.5	32.6	31.7	30.8	30.0	29.1	28.3	27.4	26.6
83	34.4	33.5	32.6	31.7	30.8	29.9	29.1	28.2	27.4	26.5
84	34.3	33.4	32.5	31.7	30.8	29.9	29.0	28.2	27.3	26.5
85	34.3	33.4	32.5	31.6	30.7	29.9	29.0	28.1	27.3	26.4
86	34.3	33.4	32.5	31.6	30.7	29.8	29.0	28.1	27.2	26.4
87	34.3	33.4	32.5	31.6	30.7	29.8	28.9	28.1	27.2	26.4
88	34.3	33.4	32.5	31.6	30.7	29.8	28.9	28.0	27.2	26.3
89	34.3	33.3	32.4	31.5	30.7	29.8	28.9	28.0	27.2	26.3
90	34.2	33.3	32.4	31.5	30.6	29.8	28.9	28.0	27.1	26.3

Ages	50	51	52	53	54	55	56	57	58	59
91	34.2	33.3	32.4	31.5	30.6	29.7	28.9	28.0	27.1	26.3
92	34.2	33.3	32.4	31.5	30.6	29.7	28.8	28.0	27.1	26.2
93	34.2	33.3	32.4	31.5	30.6	29.7	28.8	28.0	27.1	26.2
94	34.2	33.3	32.4	31.5	30.6	29.7	28.8	27.9	27.1	26.2
95	34.2	33.3	32.4	31.5	30.6	29.7	28.8	27.9	27.1	26.2
96	34.2	33.3	32.4	31.5	30.6	29.7	28.8	27.9	27.0	26.2
97	34.2	33.3	32.4	31.5	30.6	29.7	28.8	27.9	27.0	26.2
98	34.2	33.3	32.4	31.5	30.6	29.7	28.8	27.9	27.0	26.2
99	34.2	33.3	32.4	31.5	30.6	29.7	28.8	27.9	27.0	26.2
100	34.2	33.3	32.4	31.5	30.6	29.7	28.8	27.9	27.0	26.1
101	34.2	33.3	32.4	31.5	30.6	29.7	28.8	27.9	27.0	26.1
102	34.2	33.3	32.4	31.4	30.5	29.7	28.8	27.9	27.0	26.1
103	34.2	33.3	32.4	31.4	30.5	29.7	28.8	27.9	27.0	26.1
104	34.2	33.3	32.4	31.4	30.5	29.6	28.8	27.9	27.0	26.1
105	34.2	33.3	32.3	31.4	30.5	29.6	28.8	27.9	27.0	26.1
106	34.2	33.3	32.3	31.4	30.5	29.6	28.8	27.9	27.0	26.1
107	34.2	33.3	32.3	31.4	30.5	29.6	28.8	27.9	27.0	26.1
108	34.2	33.3	32.3	31.4	30.5	29.6	28.8	27.9	27.0	26.1
109	34.2	33.3	32.3	31.4	30.5	29.6	28.7	27.9	27.0	26.1
110	34.2	33.3	32.3	31.4	30.5	29.6	28.7	27.9	27.0	26.1
111	34.2	33.3	32.3	31.4	30.5	29.6	28.7	27.9	27.0	26.1
112	34.2	33.3	32.3	31.4	30.5	29.6	28.7	27.9	27.0	26.1
113	34.2	33.3	32.3	31.4	30.5	29.6	28.7	27.9	27.0	26.1
114	34.2	33.3	32.3	31.4	30.5	29.6	28.7	27.9	27.0	26.1
115	34.2	33.3	32.3	31.4	30.5	29.6	28.7	27.9	27.0	26.1

Ages	60	61	62	63	64	65	66	67	68	69
60	30.9	30.4	30.0	29.6	29.2	28.8	28.5	28.2	27.9	27.6
61	30.4	29.9	29.5	29.0	28.6	28.3	27.9	27.6	27.3	27.0
62	30.0	29.5	29.0	28.5	28.1	27.7	27.3	27.0	26.7	26.4
63	29.6	29.0	28.5	28.1	27.6	27.2	26.8	26.4	26.1	25.7
64	29.2	28.6	28.1	27.6	27.1	26.7	26.3	25.9	25.5	25.2
65	28.8	28.3	27.7	27.2	26.7	26.2	25.8	25.4	25.0	24.6
66	28.5	27.9	27.3	26.8	26.3	25.8	25.3	24.9	24.5	24.1
67	28.2	27.6	27.0	26.4	25.9	25.4	24.9	24.4	24.0	23.6
68	27.9	27.3	26.7	26.1	25.5	25.0	24.5	24.0	23.5	23.1
69	27.6	27.0	26.4	25.7	25.2	24.6	24.1	23.6	23.1	22.6
70	27.4	26.7	26.1	25.4	24.8	24.3	23.7	23.2	22.7	22.2
71	27.2	26.5	25.8	25.2	24.5	23.9	23.4	22.8	22.3	21.8
72	27.0	26.3	25.6	24.9	24.3	23.7	23.1	22.5	22.0	21.4
73	26.8	26.1	25.4	24.7	24.0	23.4	22.8	22.2	21.6	21.1
74	26.6	25.9	25.2	24.5	23.8	23.1	22.5	21.9	21.3	20.8
75	26.5	25.7	25.0	24.3	23.6	22.9	22.3	21.6	21.0	20.5
76	26.3	25.6	24.8	24.1	23.4	22.7	22.0	21.4	20.8	20.2
77	26.2	25.4	24.7	23.9	23.2	22.5	21.8	21.2	20.6	19.9
78	26.1	25.3	24.6	23.8	23.1	22.4	21.7	21.0	20.3	19.7
79	26.0	25.2	24.4	23.7	22.9	22.2	21.5	20.8	20.1	19.5
80	25.9	25.1	24.3	23.6	22.8	22.1	21.3	20.6	20.0	19.3
81	25.8	25.0	24.2	23.4	22.7	21.9	21.2	20.5	19.8	19.1
82	25.8	24.9	24.1	23.4	22.6	21.8	21.1	20.4	19.7	19.0
83	25.7	24.9	24.1	23.3	22.5	21.7	21.0	20.2	19.5	18.8
84	25.6	24.8	24.0	23.2	22.4	21.6	20.9	20.1	19.4	18.7
85	25.6	24.8	23.9	23.1	22.3	21.6	20.8	20.1	19.3	18.6
86	25.5	24.7	23.9	23.1	22.3	21.5	20.7	20.0	19.2	18.5
87	25.5	24.7	23.8	23.0	22.2	21.4	20.7	19.9	19.2	18.4
88	25.5	24.6	23.8	23.0	22.2	21.4	20.6	19.8	19.1	18.3
89	25.4	24.6	23.8	22.9	22.1	21.3	20.5	19.8	19.0	18.3
90	25.4	24.6	23.7	22.9	22.1	21.3	20.5	19.7	19.0	18.2

Ages	60	61	62	63	64	65	66	67	68	69
91	25.4	24.5	23.7	22.9	22.1	21.3	20.5	19.7	18.9	18.2
92	25.4	24.5	23.7	22.9	22.0	21.2	20.4	19.6	18.9	18.1
93	25.4	24.5	23.7	22.8	22.0	21.2	20.4	19.6	18.8	18.1
94	25.3	24.5	23.6	22.8	22.0	21.2	20.4	19.6	18.8	18.0
95	25.3	24.5	23.6	22.8	22.0	21.1	20.3	19.6	18.8	18.0
96	25.3	24.5	23.6	22.8	21.9	21.1	20.3	19.5	18.8	18.0
97	25.3	24.5	23.6	22.8	21.9	21.1	20.3	19.5	18.7	18.0
98	25.3	24.4	23.6	22.8	21.9	21.1	20.3	19.5	18.7	17.9
99	25.3	24.4	23.6	22.7	21.9	21.1	20.3	19.5	18.7	17.9
100	25.3	24.4	23.6	22.7	21.9	21.1	20.3	19.5	18.7	17.9
101	25.3	24.4	23.6	22.7	21.9	21.1	20.2	19.4	18.7	17.9
102	25.3	24.4	23.6	22.7	21.9	21.1	20.2	19.4	18.6	17.9
103	25.3	24.4	23.6	22.7	21.9	21.0	20.2	19.4	18.6	17.9
104	25.3	24.4	23.5	22.7	21.9	21.0	20.2	19.4	18.6	17.8
105	25.3	24.4	23.5	22.7	21.9	21.0	20.2	19.4	18.6	17.8
106	25.3	24.4	23.5	22.7	21.9	21.0	20.2	19.4	18.6	17.8
107	25.2	24.4	23.5	22.7	21.8	21.0	20.2	19.4	18.6	17.8
108	25.2	24.4	23.5	22.7	21.8	21.0	20.2	19.4	18.6	17.8
109	25.2	24.4	23.5	22.7	21.8	21.0	20.2	19.4	18.6	17.8
110	25.2	24.4	23.5	22.7	21.8	21.0	20.2	19.4	18.6	17.8
111	25.2	24.4	23.5	22.7	21.8	21.0	20.2	19.4	18.6	17.8
112	25.2	24.4	23.5	22.7	21.8	21.0	20.2	19.4	18.6	17.8
113	25.2	24.4	23.5	22.7	21.8	21.0	20.2	19.4	18.6	17.8
114	25.2	24.4	23.5	22.7	21.8	21.0	20.2	19.4	18.6	17.8
115	25.2	24.4	23.5	22.7	21.8	21.0	20.2	19.4	18.6	17.8

Ages	70	71	72	73	74	75	76	77	78	79
70	21.8	21.3	20.9	20.6	20.2	19.9	19.6	19.4	19.1	18.9
71	21.3	20.9	20.5	20.1	19.7	19.4	19.1	18.8	18.5	18.3
72	20.9	20.5	20.0	19.6	19.3	18.9	18.6	18.3	18.0	17.7
73	20.6	20.1	19.6	19.2	18.8	18.4	18.1	17.8	17.5	17.2
74	20.2	19.7	19.3	18.8	18.4	18.0	17.6	17.3	17.0	16.7
75	19.9	19.4	18.9	18.4	18.0	17.6	17.2	16.8	16.5	16.2
76	19.6	19.1	18.6	18.1	17.6	17.2	16.8	16.4	16.0	15.7
77	19.4	18.8	18.3	17.8	17.3	16.8	16.4	16.0	15.6	15.3
78	19.1	18.5	18.0	17.5	17.0	16.5	16.0	15.6	15.2	14.9
79	18.9	18.3	17.7	17.2	16.7	16.2	15.7	15.3	14.9	14.5
80	18.7	18.1	17.5	16.9	16.4	15.9	15.4	15.0	14.5	14.1
81	18.5	17.9	17.3	16.7	16.2	15.6	15.1	14.7	14.2	13.8
82	18.3	17.7	17.1	16.5	15.9	15.4	14.9	14.4	13.9	13.5
83	18.2	17.5	16.9	16.3	15.7	15.2	14.7	14.2	13.7	13.2
84	18.0	17.4	16.7	16.1	15.5	15.0	14.4	13.9	13.4	13.0
85	17.9	17.3	16.6	16.0	15.4	14.8	14.3	13.7	13.2	12.8
86	17.8	17.1	16.5	15.8	15.2	14.6	14.1	13.5	13.0	12.5
87	17.7	17.0	16.4	15.7	15.1	14.5	13.9	13.4	12.9	12.4
88	17.6	16.9	16.3	15.6	15.0	14.4	13.8	13.2	12.7	12.2
89	17.6	16.9	16.2	15.5	14.9	14.3	13.7	13.1	12.6	12.0
90	17.5	16.8	16.1	15.4	14.8	14.2	13.6	13.0	12.4	11.9
91	17.4	16.7	16.0	15.4	14.7	14.1	13.5	12.9	12.3	11.8
92	17.4	16.7	16.0	15.3	14.6	14.0	13.4	12.8	12.2	11.7
93	17.3	16.6	15.9	15.2	14.6	13.9	13.3	12.7	12.1	11.6
94	17.3	16.6	15.9	15.2	14.5	13.9	13.2	12.6	12.0	11.5
95	17.3	16.5	15.8	15.1	14.5	13.8	13.2	12.6	12.0	11.4
96	17.2	16.5	15.8	15.1	14.4	13.8	13.1	12.5	11.9	11.3
97	17.2	16.5	15.8	15.1	14.4	13.7	13.1	12.5	11.9	11.3
98	17.2	16.4	15.7	15.0	14.3	13.7	13.0	12.4	11.8	11.2
99	17.2	16.4	15.7	15.0	14.3	13.6	13.0	12.4	11.8	11.2
100	17.1	16.4	15.7	15.0	14.3	13.6	12.9	12.3	11.7	11.1

Ages	70	71	72	73	74	75	76	77	78	79
101	17.1	16.4	15.6	14.9	14.2	13.6	12.9	12.3	11.7	11.1
102	17.1	16.4	15.6	14.9	14.2	13.5	12.9	12.2	11.6	11.0
103	17.1	16.3	15.6	14.9	14.2	13.5	12.9	12.2	11.6	11.0
104	17.1	16.3	15.6	14.9	14.2	13.5	12.8	12.2	11.6	11.0
105	17.1	16.3	15.6	14.9	14.2	13.5	12.8	12.2	11.5	10.9
106	17.1	16.3	15.6	14.8	14.1	13.5	12.8	12.2	11.5	10.9
107	17.0	16.3	15.6	14.8	14.1	13.4	12.8	12.1	11.5	10.9
108	17.0	16.3	15.5	14.8	14.1	13.4	12.8	12.1	11.5	10.9
109	17.0	16.3	15.5	14.8	14.1	13.4	12.8	12.1	11.5	10.9
110	17.0	16.3	15.5	14.8	14.1	13.4	12.7	12.1	11.5	10.9
111	17.0	16.3	15.5	14.8	14.1	13.4	12.7	12.1	11.5	10.8
112	17.0	16.3	15.5	14.8	14.1	13.4	12.7	12.1	11.5	10.8
113	17.0	16.3	15.5	14.8	14.1	13.4	12.7	12.1	11.4	10.8
114	17.0	16.3	15.5	14.8	14.1	13.4	12.7	12.1	11.4	10.8
115	17.0	16.3	15.5	14.8	14.1	13.4	12.7	12.1	11.4	10.8

Ages	80	81	82	83	84	85	86	87	88	89
80	13.8	13.4	13.1	12.8	12.6	12.3	12.1	11.9	11.7	11.5
81	13.4	13.1	12.7	12.4	12.2	11.9	11.7	11.4	11.3	11.1
82	13.1	12.7	12.4	12.1	11.8	11.5	11.3	11.0	10.8	10.6
83	12.8	12.4	12.1	11.7	11.4	11.1	10.9	10.6	10.4	10.2
84	12.6	12.2	11.8	11.4	11.1	10.8	10.5	10.3	10.1	9.9
85	12.3	11.9	11.5	11.1	10.8	10.5	10.2	9.9	9.7	9.5
86	12.1	11.7	11.3	10.9	10.5	10.2	9.9	9.6	9.4	9.2
87	11.9	11.4	11.0	10.6	10.3	9.9	9.6	9.4	9.1	8.9
88	11.7	11.3	10.8	10.4	10.1	9.7	9.4	9.1	8.8	8.6
89	11.5	11.1	10.6	10.2	9.9	9.5	9.2	8.9	8.6	8.3
90	11.4	10.9	10.5	10.1	9.7	9.3	9.0	8.6	8.3	8.1
91	11.3	10.8	10.3	9.9	9.5	9.1	8.8	8.4	8.1	7.9
92	11.2	10.7	10.2	9.8	9.3	9.0	8.6	8.3	8.0	7.7
93	11.1	10.6	10.1	9.6	9.2	8.8	8.5	8.1	7.8	7.5
94	11.0	10.5	10.0	9.5	9.1	8.7	8.3	8.0	7.6	7.3
95	10.9	10.4	9.9	9.4	9.0	8.6	8.2	7.8	7.5	7.2
96	10.8	10.3	9.8	9.3	8.9	8.5	8.1	7.7	7.4	7.1
97	10.7	10.2	9.7	9.2	8.8	8.4	8.0	7.6	7.3	6.9
98	10.7	10.1	9.6	9.2	8.7	8.3	7.9	7.5	7.1	6.8
99	10.6	10.1	9.6	9.1	8.6	8.2	7.8	7.4	7.0	6.7
100	10.6	10.0	9.5	9.0	8.5	8.1	7.7	7.3	6.9	6.6
101	10.5	10.0	9.4	9.0	8.5	8.0	7.6	7.2	6.9	6.5
102	10.5	9.9	9.4	8.9	8.4	8.0	7.5	7.1	6.8	6.4
103	10.4	9.9	9.4	8.8	8.4	7.9	7.5	7.1	6.7	6.3
104	10.4	9.8	9.3	8.8	8.3	7.9	7.4	7.0	6.6	6.3
105	10.4	9.8	9.3	8.8	8.3	7.8	7.4	7.0	6.6	6.2
106	10.3	9.8	9.2	8.7	8.2	7.8	7.3	6.9	6.5	6.2
107	10.3	9.8	9.2	8.7	8.2	7.7	7.3	6.9	6.5	6.1
108	10.3	9.7	9.2	8.7	8.2	7.7	7.3	6.8	6.4	6.1
109	10.3	9.7	9.2	8.7	8.2	7.7	7.2	6.8	6.4	6.0
110	10.3	9.7	9.2	8.6	8.1	7.7	7.2	6.8	6.4	6.0
111	10.3	9.7	9.1	8.6	8.1	7.6	7.2	6.8	6.3	6.0
112	10.2	9.7	9.1	8.6	8.1	7.6	7.2	6.7	6.3	5.9
113	10.2	9.7	9.1	8.6	8.1	7.6	7.2	6.7	6.3	5.9
114	10.2	9.7	9.1	8.6	8.1	7.6	7.1	6.7	6.3	5.9
115	10.2	9.7	9.1	8.6	8.1	7.6	7.1	6.7	6.3	5.9

Ages	90	91	92	93	94	95	96	97	98	99
90	7.8	7.6	7.4	7.2	7.1	6.9	6.8	6.6	6.5	6.4
91	7.6	7.4	7.2	7.0	6.8	6.7	6.5	6.4	6.3	6.1
92	7.4	7.2	7.0	6.8	6.6	6.4	6.3	6.1	6.0	5.9
93	7.2	7.0	6.8	6.6	6.4	6.2	6.1	5.9	5.8	5.6
94	7.1	6.8	6.6	6.4	6.2	6.0	5.9	5.7	5.6	5.4
95	6.9	6.7	6.4	6.2	6.0	5.8	5.7	5.5	5.4	5.2
96	6.8	6.5	6.3	6.1	5.9	5.7	5.5	5.3	5.2	5.0
97	6.6	6.4	6.1	5.9	5.7	5.5	5.3	5.2	5.0	4.9
98	6.5	6.3	6.0	5.8	5.6	5.4	5.2	5.0	4.8	4.7
99	6.4	6.1	5.9	5.6	5.4	5.2	5.0	4.9	4.7	4.5
100	6.3	6.0	5.8	5.5	5.3	5.1	4.9	4.7	4.5	4.4
101	6.2	5.9	5.6	5.4	5.2	5.0	4.8	4.6	4.4	4.2
102	6.1	5.8	5.5	5.3	5.1	4.8	4.6	4.4	4.3	4.1
103	6.0	5.7	5.4	5.2	5.0	4.7	4.5	4.3	4.1	4.0
104	5.9	5.6	5.4	5.1	4.9	4.6	4.4	4.2	4.0	3.8
105	5.9	5.6	5.3	5.0	4.8	4.5	4.3	4.1	3.9	3.7
106	5.8	5.5	5.2	4.9	4.7	4.5	4.2	4.0	3.8	3.6
107	5.8	5.4	5.1	4.9	4.6	4.4	4.2	3.9	3.7	3.5
108	5.7	5.4	5.1	4.8	4.6	4.3	4.1	3.9	3.7	3.5
109	5.7	5.3	5.0	4.8	4.5	4.3	4.0	3.8	0.6	3.4
110	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.8	3.5	3.3
111	5.6	5.3	5.0	4.7	4.4	4.2	3.9	3.7	3.5	3.3
112	5.6	5.3	4.9	4.7	4.4	4.1	3.9	3.7	3.5	3.2
113	5.6	5.2	4.9	4.6	4.4	4.1	3.9	3.6	3.4	3.2
114	5.6	5.2	4.9	4.6	4.3	4.1	3.9	3.6	3.4	3.2
115	5.5	5.2	4.9	4.6	4.3	4.1	3.8	3.6	3.4	3.1

Ages	100	101	102	103	104	105	106	107	108	109
100	4.2	4.1	3.9	3.8	3.7	3.5	3.4	3.3	3.3	3.2
101	4.1	3.9	3.7	3.6	3.5	3.4	3.2	3.1	3.1	3.0
102	3.9	3.7	3.6	3.4	3.3	3.2	3.1	3.0	2.9	2.8
103	3.8	3.6	3.4	3.3	3.2	3.0	2.9	2.8	2.7	2.6
104	3.7	3.5	3.3	3.2	3.0	2.9	2.7	2.6	2.5	2.4
105	3.5	3.4	3.2	3.0	2.9	2.7	2.6	2.5	2.4	2.3
106	3.4	3.2	3.1	2.9	2.7	2.6	2.4	2.3	2.2	2.1
107	3.3	3.1	3.0	2.8	2.6	2.5	2.3	2.2	2.1	2.0
108	3.3	3.1	2.9	2.7	2.5	2.4	2.2	2.1	1.9	1.8
109	3.2	3.0	2.8	2.6	2.4	2.3	2.1	2.0	1.8	1.7
110	3.1	2.9	2.7	2.5	2.3	2.2	2.0	1.9	1.7	1.6
111	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.8	1.6	1.5
112	3.0	2.8	2.6	2.4	2.2	2.0	1.9	1.7	1.5	1.4
113	3.0	2.8	2.6	2.4	2.2	2.0	1.8	1.6	1.5	1.3
114	3.0	2.7	2.5	2.3	2.1	1.9	1.8	1.6	1.4	1.3
115	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.4	1.2

Ages	110	111	112	113	114	115+
110	1.5	1.4	1.3	1.2	1.1	1.1
111	1.4	1.2	1.1	1.1	1.0	1.0
112	1.3	1.1	1.0	1.0	1.0	1.0
113	1.2	1.1	1.0	1.0	1.0	1.0
114	1.1	1.0	1.0	1.0	1.0	1.0
115	1.1	1.0	1.0	1.0	1.0	1.0

APPENDIX H: MORTALITY TABLE

USED TO FORMULATE THE SINGLE LIFE TABLE IN §1.401(a)(9)-9, Q&A-1

Age	lx	qx	Age	lx	qx	Age	lx	qx
0	1000000	0.001982	41	979614	0.000904	82	608287	0.051767
1	998018	0.000802	42	978728	0.001007	83	576798	0.057393
2	997218	0.000433	43	977742	0.001130	84	543694	0.063584
3	996786	0.000337	44	976637	0.001270	85	509124	0.070397
4	996450	0.000284	45	975397	0.001426	86	473283	0.077892
5	996167	0.000248	46	974006	0.001596	87	436418	0.086124
6	995920	0.000221	47	972451	0.001783	88	398832	0.095238
7	995700	0.000201	48	970717	0.001979	89	360848	0.105069
8	995500	0.000222	49	968796	0.002187	90	322934	0.115519
9	995279	0.000241	50	966677	0.002409	91	285629	0.126486
10	995039	0.000259	51	964348	0.002646	92	249501	0.137875
11	994781	0.000277	52	961796	0.002896	93	215101	0.149418
12	994505	0.000292	53	959011	0.003167	94	182961	0.161176
13	994215	0.000306	54	955974	0.003453	95	153472	0.173067
14	993911	0.000318	55	952673	0.003754	96	126911	0.185012
15	993595	0.000331	56	949097	0.004069	97	103431	0.196920
16	993266	0.000344	57	945235	0.004398	98	83063.4	0.210337
17	992924	0.000359	58	941078	0.004736	99	65592.1	0.224861
18	992568	0.000375	59	936621	0.005101	100	50843	0.241016
19	992196	0.000392	60	931843	0.005510	101	38589	0.259333
20	991807	0.000411	61	926709	0.005975	102	28581.6	0.280355
21	991399	0.000432	62	921172	0.006512	103	20568.6	0.303142
22	990971	0.000454	63	915173	0.007137	104	14333.4	0.329482
23	990521	0.000476	64	908641	0.007853	105	9610.8	0.359886
24	990050	0.000501	65	901505	0.008670	106	6152.01	0.394864
25	989554	0.000524	66	893689	0.009591	107	3722.8	0.434933
26	989035	0.000547	67	885118	0.010620	108	2103.63	0.480598
27	988494	0.000567	68	875718	0.011778	109	1092.63	0.532376
28	987934	0.000584	69	865404	0.013073	110	510.94	0.590774
29	987357	0.000598	70	854091	0.014520	111	209.09	0.656307
30	986767	0.000608	71	841690	0.016139	112	71.8628	0.729485
31	986167	0.000615	72	828106	0.017951	113	19.44	0.810817
32	985561	0.000619	73	813241	0.019958	114	3.67772	0.900819
33	984951	0.000622	74	797010	0.022198	115	0.36476	1.000000
34	984338	0.000625	75	779318	0.024699			
35	983723	0.000629	76	760070	0.027484			
36	983104	0.000636	77	739180	0.030583			
37	982479	0.000657	78	716574	0.034010			
38	981834	0.000696	79	692203	0.037807			
39	981151	0.000749	80	666033	0.042010			
40	980416	0.000818	81	638053	0.046651			

GLOSSARY

Account Aggregation The concept of combining multiple IRA accounts into one account.

Account Fracturing The concept of splitting an IRA account into multiple account, typically before the commencement of SEPPs.

AGC Assistant General Counsel's Office of the Internal Revenue Service. Generally, the AGC is responsible for policy making and issuance of private letter rulings.

AFR Applicable federal (interest) rate. There are short-term, mid-term and long-term AFRs used for a variety of purposes. SEPP programs, commencing in 2003 are limited to 120% of the mid-term AFR in force for either of the two months preceding the 1st date of distribution. AFRs are computed monthly by the Department of Treasury & then transmitted to the IRS for publication in Revenue Procedures.

Amortization Method One of the three computational methods permitted for SEPPs as identified in Revenue Ruling 2002-62.

Annual Recalculation The process of using one's updated age, IRA account values and life expectancy divisors to determine the correct distribution for the year.

Annuity Method One of the three computational methods permitted for SEPPs as identified in Revenue Ruling 2002-62.

Attained Age Meaning one's highest attained age within a calendar.

Basis A taxpayer's lifetime-to-date after-tax contributions to a deferred account.

COLA Cost of Living Adjustment.

Conversion The ability to move assets from a regular IRA to a ROTH IRA resulting in a taxable, but not surtaxed, transaction such that future period withdrawals will become tax free.

Cumulative Bulletin or C.B. A collection of documents including: Notices, Rulings, Revenue Procedures that is published weekly by the IRS in serial fashion.

Deferred Account Refers collectively to all assets housed inside tax-deferred plans, such as: §401(a) plans, §401(k) plans, §403(b) plans, as well as all types of IRAs.

Defined Benefit (Plan) A plan, usually 100% employer funded that promises a future period specific periodic payment to an employee.

Defined Contribution (Plan) A plan, usually funded by employees and employers that does not promise a future period payment. Instead, the employee is guaranteed the cash contents of the account upon separation of service.

Diminimus A small amount. In this context \$1.00 or less.

Distribution Same as withdrawal.

Earned Income Income acquired through the use of one's labors, typically reported on a W-2 as wages or a 1099M for self-employed.

Employee Used synonymously with “account owner” and “taxpayer” to indicate the owner or beneficiary of a deferred account.

Error, Theory A misinterpretation of a basic concept of tax law.

Error, Practice An administrative or mathematical error in the application of theory.

Exhaustion A deferred account which prematurely runs out of assets before satisfying the law or before its intended time period, typically a lifetime.

IRA Individual Retirement Account, Arrangement or Annuity.

IRA, Contributory An IRA into which a taxpayer makes annual contributions which may or may not be tax deductible.

IRA, Rollover An IRA that receives the assets from a qualified plan through a rollover or trustee-to-trustee transfer.

IRB Internal Revenue Bulletin which is published weekly by the IRS.

IRC Internal Revenue Code (as enacted by the U.S. Congress).

IRP Individual Retirement Plan (different than and a subset of QRPs) defined in IRC §7701(a)(37) as individual retirement accounts and individual retirement annuities defined in IRC §408(a) & 408(b) respectively.

IRS Internal Revenue Service, Department of Treasury.

Joint & Survivor Life The future life expectancy of the last to die of two individuals of same or different ages.

Life Expectancy Table A table of averaged or anticipated life expectancy based upon one’s already achieved age. Life expectancy tables govern a portion of the mathematics used to determine annual distributions using any of the three approved methods.

LT/AFR Long-term applicable federal rate. See AFR.

Look Back Tax A provision in the IRC which causes transactions (typically SEPPs) to be reclassified such that multiple tax years are affected and recalculated to arrive at a new tax due amount for the sum of the years.

Modification Prematurely changing the pattern of SEPP distributions such that the SEPP plan becomes disqualified and the 10% surtax is imposed.

MT/AFR Mid-term applicable federal rate. See AFR.

Notice A document authored and published by the IRS that should be considered a primary authority on the subject matter at hand.

NUA Net Unrealized Appreciation (in conjunction with employer securities).

PBGC Pension Benefit Guarantee Corporation. An institution not unlike the FDIC or FSLIC for private pension plans.

PLR Private Letter Ruling.

Publication A document authored and published by the IRS that should be considered a secondary source on a subject. Publications are attempted to be written in plain English for consumption by the general public.

QDRO Qualified Domestic Relations Order. Usually issued by a judge pursuant to a divorce proceeding that will govern the splitting of deferred account assets between ex-spouses.

QRP Qualified Retirement Plan; IRC §4974©). In general all plans receiving qualification from IRC §§ 401(a), 403(a), 403(b), 408(a) & 408(b).

Qualified Plan Any deferred asset savings plan---defined contribution or defined benefit; all of which are “qualified under IRC §§401-416. IRA are specifically not qualified plans. It is the “qualified” designation that causes the tax deferral on assets held within the plan and further provides the plan sponsor (usually an employer) with a tax deduction for any contributions to the plan.

Qualified Withdrawal A withdrawal made from a ROTH IRA after the expiration of a “5 year period” and the account owner attaining the age of 59 ½ or greater.

Required Minimum Distribution Method One of the three computational methods permitted for SEPPs as identified in Revenue Ruling 2002-62.

Regulation. A written pronouncement from the IRS that is broad in scope that generally discusses theory and practice regarding one or more areas of the IRC. Regulations should always be considered as law.

Revenue Procedure. A written pronouncement from the IRS that tends to be procedural in nature often defining how a taxpayer should interact with the IRS. Secondly, Revenue Procedures are used to publish repetitive data; such as monthly applicable federal rates.

Revenue Ruling. A written pronouncement from the IRS generally discussing a tactical issue. Revenue rulings should be considered as law.

Reversibility Typically refers to the ability to make a tax decision in one time period and retain the ability to reverse that decision in a later time period. This ability is not available with SEPPs.

Rollover The method by which an employee can move deferred assets from location to another. Usually, the trustee is required to withhold 20% of the assets as a tax withholding.

ROTH IRA A special type of IRA, championed by Senator ROTH, where distributions become tax free after the passage of 5 years and the owner attaining age 59 1/2.

§72(t) The IRC code section that governs the taxation of withdrawals from all deferred accounts.

SEP A Simplified Employee Pension. Not to be confused with SEPP.

Separated As in a separation of service from an employer.

SEPP Substantially Equal Periodic Payment.

SEPP Plan A taxpayer designed series of deferred account withdrawals designed to both meet the taxpayers needs as well as the IRC such that the distributions are not surtaxed.

SEPP Universe A collection of two or more deferred accounts, segregated from all other deferred accounts that are specifically identified

as the asset base from which SEPP withdrawals will be made.

Single Life One's average, future life expectancy based upon the attained age of one individual.

Sponsor The enabling entity that creates a deferred plan or trust, usually an employer or collective bargaining unit such as a union.

Surtax An additional tax on top of regular taxes; in this case computed as 10% of the amount withdrawn from a deferred account.

Tax Deferred Implying that the results of a transaction are not currently taxed but will be taxed in some future time period.

Tax Free Implying that the results of a transaction result in no income tax due.

Taxpayer Used synonymously to mean the employee who is the beneficiary of a deferred account.

TCM Tax Court Memorandum.

Transfer Usually meaning "trustee-to-trustee" transfer as a method for an employee to move deferred assets from one location to another. In contrast to a "rollover", no tax withholding occurs.

Trust A separate legal entity as distinguished from an employer/plan sponsor, which is responsible for the safekeeping of all assets inside a qualified plan or IRA.

Trustee An officer of a Trust.

Uniform Life The average life expectancy of the last to die of two individuals, the first individual at attained age and the second individual exactly ten years junior to the first individual.

UP-1984 A mortality table, no longer in use, published by the Society of Actuaries.

Withdrawal The removal of assets, usually in cash, from a deferred account.

Unearned Income Income acquired through the employment of financial assets such as distributions from IRAs, as well as normal interest and dividends.

Unqualified Withdrawal Any withdrawal made from a ROTH IRA that is not qualified.