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Accessing Retirement Savings Before 59½: Review of Updates to 72(t) Rules

By Jeffrey Levine, CPA/PFS, CFP

The IRS released new guidance with respect to calculating and distributing 72(t) payments late last year. Here is a refresher on the update and some tips on good 72(t) planning.

In December 2021, the IRS released Notice 2022-06, which provides new guidance with respect to calculating and distributing 72(t) payments.

As a reminder, 72(t) payments are a way of allowing clients who are younger than 59½ to access a portion of their retirement savings without a penalty. Distributions must be calculated using one of three IRS-approved methods (annuitization, amortization, RMD), and must last for the longer of five full years, or until the individual reaches 59½.

Notice 2022-06 provides a number of important updates and changes to the rules, including:

- The annuitization and amortization methods may now be calculated using an interest rate factor that is the greater of 120% of the Applicable Federal Mid-Term Rate (AFR), or 5%. Previously, the maximum interest rate that was allowed was "just" 120% of the AFR. The new 5% rate can be used immediately (for newly created 72(t) payment plans).

  As a result of this change, the maximum 72(t)-payment that can be generated from an account today is dramatically increased. For example, using an interest rate of 1.57% (the maximum percentage that would have been allowed for a 72(t)-payment beginning in January 2022 prior to the release of Notice 2022-06), the maximum annual 72(t) payment that could have been generated for a 50-year-old IRA owner with a $1 million IRA balance would have been just north of $38,000. By contrast, using the new 5% floor interest rate, the maximum annual 72(t) payment rises to more than $61,600!

- For taxpayers using the RMD method, the "old" (pre-2020) life expectancy tables can continue to be used for payments this year. Alternatively, taxpayers can use the "new" life expectancy tables published by the IRS in 2020, which became effective this year for RMDs. Beginning in 2023, taxpayers using the RMD method must use the new tables to calculate annual 72(t) payments, regardless of when the schedule was first established.

  It's important to remember that 72(t) payment schedules require strict compliance with a number of rules for a minimum of five years. Thus, they should generally be considered only after most other cash-flow options have been exhausted. However, when they are necessary, it is essential that advisors help clients to minimize the risk of such plans.

  To that end, ***a central tenet of good 72(t) planning is to create the largest payment from the smallest possible balance***. Any "excess" account balance that is not needed to produce the desired 72(t) payment should be transferred to another retirement account, prior to the start of the schedule, so as to avoid encumbering those assets with the rigid 72(t) restrictions. The introduction of the 5% floor in the maximum rate that can be used when calculating payments should be helpful in this regard.

Separately, since the RMD method generally produces the lowest payment amount of the three methods, it should generally not be used for new schedules (because, as noted above, the initial goal is to create the largest payment from the smallest balance). That said, where a previously established payment schedule is no longer needed (e.g., the client went back to work and doesn't need the income anymore), a one-time switch from either the annuitization or amortization methods to the RMD method can minimize further "leakage" from a client's retirement account, while still avoiding a modification (breaking) to a client's 72(t) schedule (which can trigger retroactive penalties and interest). And to that end, since the new RMD tables provide for factors that will reduce an individual's required 72(t) payment, in most situations using the new tables this year (which is voluntary) to calculate the 2022 distribution will be the optimal choice.

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