Tough Decisions; Fiftysomething Retirees May Have To Choose Between Emptying IRAs And Slashing Spending

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The recent bear market has not affectedall investors equally. Clients who are still working could potentially have years to buy stocks at fire-sale prices. Older retired clients have Social Security checks, pensions in some cases, bond interest and-with good planning-enough of a cash reserve to defer selling their depressed stocks.

Early retirees, however, may be the ones that are hit the hardest. Before age 62, they can't collect Social Security. Further, if they're under age 591/2, they may have to draw down their IRAs, relying on 72(t) rules to avoid early withdrawal penalties.

"In some cases, these early retirees face difficult choices: They can either cut their spending sharply, deplete their IRAs or even go back to work at what is likely to be a much lower salary than they had before," says Bob Keebler, a partner in the accounting firm of Virchow, Krause & Co. in Green Bay, Wis.

WORKING THE TAX CODE

Financial planners can help clients make the best of these unpleasant circumstances if they are familiar with section 72(t) of the tax code. In order to avoid a 10% penalty on IRA withdrawals before age 591/2, many early retirees take a series of substantially equal periodic payments (SOSEPP). If they do not maintain SOSEPP for five years or until they reach age 591/2, whichever comes later, all early IRA withdrawals are subject to the 10% surtax.

The IRS has approved three methods for calculating a SOSEPP: amortization, annuitization and minimum distribution. In practice, most people choose either the amortization or annuitization methods, both of which permit relatively large penalty-free withdrawals.

Under the amortization and annuitization methods, the same amount must be taken out every year, Both methods require the taxpayer to choose an interest rate and assume the IRA will grow at that rate. Under the minimum distribution method, payments vary each year, based on changing account values and decreasing life expectancies; this method produces much smaller withdrawals.

Assume 50-year-old James Smith started a SOSEPP in 2005 with a $1 million IRA. "Under the annuitization method, this taxpayer would be taking approximately $60,700 a year from the IRA," says Barry Picker, of Picker, Weinberg & Auerbach, a CPA firm in Brooklyn, N.Y. If the IRA has declined to $600,000 in the 2008 bear market, continuing the required SOSEPP until 2014 would strip approximately $365,000 from Smith's retirement account and might leave less than 25% of the original IRA balance.

What might planners suggest to clients in this situation? There are several solutions.

PAY THE PENALTY

If Smith doesn't want to shrink his retirement fund, he could stop the SOSEPP and take smaller amounts via a new SOSEPP. However, he already has taken more than $180,000 from his IRA in the first three years.

"Canceling the SOSEPP would result in a penalty of more than $18,000, plus an additional penalty to reflect interest on the penalty for the earlier years," Picker says. "I don't believe it's worth it, and I would not recommend that option."

The situation might be different, though, if Smith were only one year into his SOSEPP, having withdrawn only $60,700 from his IRA. In that case, he might choose to pay a 10% penalty of around $6,000 and set up a new SOSEPP with his $600,000 balance. Paying a relatively small surtax may be an attractive solution for clients who are 57 or 58 years old; if they can minimize ongoing withdrawals for a couple of years, they can tap their IRA penalty-free, once they reach 591/2.

SUSTAIN THE SOSEPP

Another option would be for Smith to stay on his original schedule, thus avoiding penalties altogether. This approach may be viable if his IRA has fallen only by 20%, rather than by 40% as in the example above.

"A properly diversified and allocated portfolio may not have declined as much as the broad market indexes," points out Virginia Stanley of REDW Stanley Financial Advisors in Albuquerque, N.M. Her firm's portfolios were down about 20% at the time the S&P 500 was off around 40% from its peak. If Smith's $1 million IRA had fallen to $800,000 instead of $600,000, maintaining the original $60,700 annual distributions would not be as damaging.

What's more, a client whose SOSEPP depletes his IRA does not have to wind up without a retirement fund. "Just because someone has a large distribution doesn't mean he or she has to spend it in the same year," Stanley says. IRA withdrawals can be reinvested in a taxable account.

Clients who are taking a SOSEPP might take the distributions in kind, according to Stanley. "Rather than taking cash from the IRA, transferring securities held in the IRA to a regular account may make sense," she says.

For instance, assume Smith were to draw down his IRA by continuing his SOSEPP. Doing so could mean paying income tax on $365,000 rather than on the $600,000 or so that those securities were worth back in 2005. With in-kind transfers, he would hold the same securities in a taxable account. If those securities are eventually sold, any gains since the in-kind transfer might be taxed at favorable long-term capital gains rates. "This could turn out to be less of a tax liability than paying ordinary income tax on larger IRA distributions," Stanley says.

If clients decide to continue an extremely large SOSEPP, they should know when enough is enough. "Clients making the 72(t) election must understand that they can stop after taking distributions for five years or until 591/2, whichever is longer," Stanley says. "Some people might continue to take these payments even though they're no longer required."

If the client is 591/2, a SOSEPP can stop once he or she has taken five full years' worth of payments. For example, a client who started in 2007 must take payments at least through 2011. A client who has taken those five years' worth of payments, but who is not yet 591/2, must continue until the calendar year he or she reaches that age. "The rules regarding the age 591/2 stopping point are not spelled out precisely," says Ed Slott, a CPA in Rockville Centre, N.Y., and publisher of Ed Slott's IRA Advisor newsletter. "However, you probably can avoid a penalty by taking a full distribution for that year. If you'd like to minimize IRA distributions, you're probably safe if you take a pro rata withdrawal that year."

Suppose, for example, Jane Harris started a SOSEPP in 2007 and turns 59 in March 2013. She will be 591/2 in September 2013. This client can probably take a full 2013 distribution, penalty-free, or take three-quarters of the annual amount (nine of 12 months), if she'd rather minimize withdrawals that year.

Once the SOSEPP ends, clients can take as much or as little from an IRA as they wish, penalty-free, until they pass age 701/2 and the minimum required distributions begin.

PARE THE PAYMENTS

Another option is available to early retirees now as a result of the 2000-2002 bear market, when IRAs also dwindled. In response, the IRS issued Revenue Ruling 2002-62. This option permits taxpayers using the amortization or annuitization methods to make a onetime switch to the minimum distribution method. Such a switch allows the SOSEPP to continue, penalty-free, with much smaller distributions

Switching methods in this manner allows taxpayers to avoid retroactive penalties and penalties on those penalties, but it cuts sharply into the amount an early retiree can draw from the IRA. If James Smith switched to the minimum distribution method, he would withdraw about $19,700 in 2009, down from $60,700 in 2008, Picker says.

"In most cases, the change in methods would begin in 2009 rather than at the year-end 2008. That is because you can make the change after you've taken more money from your IRA in a calendar year," Keebler says.

Typically, taxpayers using a SOSEPP will take regular withdrawals to cover living expenses, according to Keebler. If Smith is withdrawing around $60,000 a year, he'd probably be pulling out about $5,000 a month from his IRA. By December 2008, when he has already withdrawn $55,000 during the year, he can't change to the minimum distribution method, which calls for an annual withdrawal of around $20,000. In January 2009, though, Smith can change to the minimum distribution method for the year and cut his monthly withdrawals to approximately $1,650.

In 2009, Smith would have only one-third of the cash flow from his IRA, compared with his 2008 withdrawal. The minimum distribution method calls for annual recalculation, as the IRA balance moves up or down, but it's unlikely that future withdrawals would be anywhere near the $60,000+ that Smith has been accustomed to receiving.

"A taxpayer in this situation might have to reduce spending dramatically," Keebler says. "More likely, he or she would try to find a job to increase income. From what I've seen, though, people who retire early and then go back to work often wind up making about one-third of their previous salary."

WAIT AND SWITCH

Picker suggests another strategy for clients in this situation. "I'd have Smith determine the minimum amount that he actually needs to get by," he says. "Say it's $35,000 a year. I would advise him to continue the original SOSEPP for another two or three years, taking out the $60,700 per year."

If Smith can live on $35,000 but withdraws $60,700, the excess $25,700 per year can go into a cash account. "After those two or three years, he can switch to the minimum distribution method, using the banked amount to supplement those withdrawals," Picker says. Assuming the minimum distribution is still around $20,000 per year, Smith could take $15,000 a year from this cash reserve to maintain his new, modest standard of living.

PRIVATE ANSWER

Picker believes that astute planning will help clients avoid the need for such stringent withdrawals. "I always try to get my clients to get a private letter ruling (PLR) to allow annual recalculation," he says. "Then they won't be in this situation."

With the "annual recalculation" that Picker mentions above, IRA owners start a SOSEPP using the amortization or the annuitization method to get large penalty-free distributions. However, they are able to recalculate their distribution each year, so that it rises or falls with their IRA balance. If an IRA falls from $1 million to $600,000, for example, the penalty-free distribution would drop by about 40%.

The exact amount depends on the annual change in the taxpayer's life expectancy, as well as on interest rate movements. Each year's payment is recalculated based on the previous year's December 31 account balance, a comparable current interest rate and the age the IRA owner reaches that year.

A client who wishes to use annual recalculation (also known as the hybrid method) has to adopt it in advance. There is no specific authorization for this tactic. However, as Picker's comments indicate, the IRS has approved such a switch in some PLRs. "Requesting a PLR costs $9,000," Picker says. "Counting professional fees, the total cost might be $17,500 to $20,000. Some clients will pay for a PLR while others won't; with a large IRA, they should request one. Paying the price beats having to deal with a problem like Smith is facing."

DELAYED GRATIFICATION

Keebler recommends another, more basic way for early retirees to keep their IRAs from vanishing. "Clients can keep working longer," he says. By staying even a few more years at their presumably well-paying jobs, clients can rebuild diminished IRAs rather than draw down these retirement accounts. Putting IRA money into depressed stocks now may result in a long period of tax- deferred growth.

If clients work until 591/2, there will be no need for a SOSEPP because the 10% penalty won't apply. Clients who work until 62 can get Social Security, if needed, and thus take less or nothing at all from their IRA, extending tax deferral. "Now that we've had two significant bear markets in the past eight years, the risks of retiring early and relying on your savings to last over a long retirement are becoming clear," Keebler says. FP

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