Special distribution choices for your IRA

Jones (name fictitious, but the facts are true) had opened a Rollover IRA when he decided to retire in his early 50s, after a long and successful career with his company. He rolled over his lump sum distribution from the company retirement plan into an IRA.

The strategy

After a relatively short time, Jones realized that his current income wasn't going to be enough to meet his needs. He turned to his Rollover IRA for assistance.

Withdrawals from his IRA were a possibility but came at a price. Whatever he took out would be taxed at ordinary income tax rates—an acceptable consequence in exchange for the years of tax-deferred accumulation that his investments had earned. What was less acceptable was the fact that, because he was under age 59 1/2, whatever he withdrew would be hit with an additional 10% tax.

Fortunately, there are several instances when certain distributions can escape the tax. One of them is to establish a schedule of payments—"substantially equal periodic payments," as the IRS calls them—that would be paid out annually over Jones' lifetime (or that of Jones and his IRA beneficiary).

In other words, Jones could supplement his income with annual payments ["Section 72(t) withdrawals"] from the IRA, paying only regular income tax on what he received. It was a good option, he thought, and moved forward with this plan.

The payment plan

Before we continue with Jones' story, we need to take a closer look at how Section 72(t) withdrawals are fashioned.

The IRS outlines three methods for Section 72(t) withdrawals. According to what was a well-established rule, once a choice is made, it is set in stone—no change is permitted. With two of the three methods, the IRA owner receives fixed annual payments. Jones chose one of these methods. He assumed an average annual 9% long-term growth for his Rollover IRA—which was worth approximately $2 million—making his annual distributions $180,000 a year.

Then, so to speak, the walls came tumbling down. Jones' IRA suffered major losses. He reacted by moving his IRA assets into low-risk investments with an expected annual return of, at best, approximately 5%.

The end result: Before he knew it, Jones' IRA had only $1.2 million in assets. This figure led him to the shocking realization that his IRA could become extinct at a future date.

[In reality, Section 72(t) withdrawals may be altered after the longer of five years or upon reaching age 59 1/2—meaning that Jones will be able at some point to take steps to staunch the flow of income from his IRA.]

A one-time reprieve from IRS

But, fortunately, Jones doesn't have to wait. There's a happy ending to the story (and, perhaps, for anyone else in a similar situation). The IRS has ruled that IRA owners who selected one of the two Section 72(t) fixed-withdrawal methods are entitled to make a one-time only switch to the third method.

Under the third method, withdrawals are determined based upon life expectancy and are figured according to account balance size, rather than requiring withdrawal of a fixed amount. In Jones' case, with a relatively long life ahead, the size of his Section 72(t) withdrawals will drop dramatically.

Although the switch means a smaller income stream from his Rollover IRA, Jones gains the benefit of time. As a young retiree, he can look forward, optimistically, to a time of portfolio growth and more attractive returns.

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