Steve Sternberger's
B·E·S·T
Business and Estate Strategies and Tips
"The monthly newsletter for the professional insurance representative"

With this issue of BEST, I'd like to introduce yet another guest contributor, Colleen M. Phalen, CIRF, Lead Tax Product Reporting Specialist for OM US Tax Group for OMFN. Colleen joined the company with over 20 years experience in regulatory compliance, systems, and operations management. She began her career in the finance industry with a federal savings bank located in Utica, New York. Since then, she has focused on product regulatory and tax compliance at the federal and state levels. Colleen has been a speaker at several industry conferences throughout the country on regulatory compliance topics and is a member of several advisory groups focusing on tax systems compliance.

Avoiding Early Withdrawal Penalties from Non-qualified Annuities Using IRC Section 72(q)

Concept: Many clients purchasing non-qualified deferred annuity contracts may find themselves in a situation where they need income from their deferred annuity prior to the annuity starting date, and often prior to reaching age 59 ½. The problem is, the IRS generally imposes a 10% penalty on the amount withdrawn from a deferred annuity for people who take the funds before age 59 ½.

A solution to this tax-penalty dilemma is available under Section 72(q) of the Internal Revenue Code. Section 72(q) provides exceptions to the 10% early withdrawal penalty normally assessed on distributions from non-qualified annuities prior to the owner's attainment of age 59 ½. One exception requires that substantially equal periodic payments be taken from the account for a minimum of five years, or until attainment of age 59 ½, whichever term of years is longer. Many clients (and their advisors) lose sleep attempting to find creative ways of accessing account funds, but 72(q) is simple to understand, easy to implement, and available to everyone.

SEPP at a glance	
IRS approved calculation methods	➢ Fixed amortization ➢ Fixed annuitization ➢ Required minimum distribution
Duration of payments	At least five years or until you reach age 59 1/2, whichever is longer
10% penalty tax	No*

* Unless the account owner fails to meet the IRS requirements.

Which of your clients will benefit by taking substantially equal periodic payments under Section 72(q)?

Market: Clients who need to access their money prior to retirement, or those who want to use their retirement assets to pay for life insurance premiums, mortgage payments, and/or other ongoing expenses.

Case Study: Jane (age 53) is the owner of a non-qualified deferred annuity that she funded with money from a bank savings account. She had planned to live off her other assets until age 59 ½. Unfortunately, due to a change in circumstances, she finds herself needing to access her account in order to cover her cash flow needs. She makes an appointment to meet with you, her financial advisor, to discuss this situation.

Primarily, she is concerned about the 10% early withdrawal penalty on distributions made prior to age 59 ½. This penalty is imposed on premature distributions from non-qualified annuities, except under specific exceptions, including death, disability, and the taking of substantially equal periodic payments as described above. You explain to Jane that these payments would be based on her life expectancy at the time that distributions from the account commence and depending on the distribution method chosen, and a specified interest rate. (See discussion below of acceptable interest rates). Jane learns she can take distributions from the annuity every year from now until she reaches age 59 ½ and avoid the 10% early withdrawal penalty on the entire income stream. Once she reaches 59 ½, the early withdrawal penalty is no longer applicable and she is free to do as she wishes with the remaining account balance.

Solution: Jane elects to take substantially equal periodic payments from her non-qualified annuity. The IRS has published guidance addressing the acceptable withdrawal calculation methods available to Jane under section 72(q). Distributions under 72(q) can be calculated three different ways: under the life expectancy, amortization, or annuitization methods. Once the distribution stream begins, it generally cannot be altered in any way without triggering retroactive tax AND interest penalties. It is important, then, that the client make the correct choice in selecting a distribution method upfront. The annuitization method will usually generate the largest distributions and, like the amortization method, results in a payment that will be the same every time a payment is made. Alternatively, withdrawals under the life expectancy method produce the smallest initial payment but will increase each year. You obtain an illustration of all three methods in one easy-to-compare illustration thereby helping you and your clients identify the best alternative to meet the client's specific needs and objectives.

Comparison of 3 Methods

Let us consider a 50-year-old man whose annuity has a value of $100,000 and whose designated beneficiary is 45 years old. The chart indicates his initial annual payment under each of the three calculation methods and the examples shows all three life expectancy tables.

Comparison			
Calculation Method	**Single Life**	**Joint Life & Last Survivor**	**Uniform Life Table**
RMD (initial payment)	$2,924	$2,315	$2,151
Fixed Amortization	$5,784	$5,290	$5,167
Fixed Annuitization	$5,727	$5,727	$5,727

Action Steps:

1) Explain 72(q) to clients who may wish to access their existing non-qualified annuity balances prior to attaining age 59 ½.
2) Prepare a 72(q) illustration for interested clients.
3) Complete and submit paperwork for a 72(q) distribution when warranted.

Interest Rate Note*:* IRS Notice 89-25 was modified by Revenue Ruling 2002-62, Notice 2004-9, Notice 2004-15 which specified that distributions under 72(q) be calculated using an interest rate that is not more than 120% of the mid-term rate determined in accordance with IRC Section 1274(d) for either of the two months immediately preceding the month in which the distributions begin.

In summary, clients run into situations where they need income from their deferred annuity before the annuity start date and age 59 ½. One solution is substantially equal periodic payments. Substantially equal periodic payments do not subject the client to the early withdrawal penalty imposed by the Internal Revenue Service. Find the best method that meets your client's needs from one of the three methods available and complete the paperwork and submit to our Service Center for processing.

Good Selling!

As edited by --

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