Morgan Stanley

72(t) Distributions

A Guide to Taking 72(t) Distributions From Your IRA

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Millions of Americans have found Individual Retirement Accounts (IRAs) to be an attractive, tax-favored means of saving for retirement.

Understanding the 72(t) Substantially Equal Payments Framework

Individual Retirement Accounts are intended to be long-term savings vehicles to fund your retirement. To discourage early withdrawals, the federal government generally imposes an additional tax of 10% on withdrawals made before age 59½, in addition to any income tax owed on these distributions.[1] However, the federal government recognizes that individuals may need to tap their retirement funds before age 59½ and permits premature withdrawals without the 10% tax penalty in certain limited circumstances, including:

- Disability (as defined under federal tax law) or death of the IRA owner
- Payment of certain medical expenses that exceed 7.5% of your Adjusted Gross Income for a taxable year
- Payment of health insurance premiums if you've been unemployed for at least 12 weeks and certain other conditions are satisfied
- Payment of qualified higher education expenses
- Payment of qualified first-time homebuyer expenses (there is a $10,000 lifetime limit on these withdrawals)
- A qualified birth or adoption distribution (up to $5,000 per qualifying birth or adoption)
- Payment of IRS tax levies
  - A qualified disaster distribution (up to $22,000 per disaster)
  - Payment due to a terminal illness (subject to certain requirements)
- Series of Substantially Equal Periodic Payments calculated based on life or life expectancy

The series of "substantially equal periodic payments" are commonly referred to as 72(t) distributions. Under this provision, you can take a series of withdrawals from your IRA before age 59½ under one of three distribution methods approved by the IRS. Once started, you must continue your 72(t) distributions for five years beginning with the date of the first payment or until age 59½, whichever is longer.

Thereafter, you are free to take any distribution from your IRA as permitted by law.

If you need or want to take 72(t) distributions, plan carefully. Taking regular distributions from your IRA ▶

before age 59½ may leave you with insufficient assets to fund your future retirement needs. You may not ultimately attain the rate of return you estimate when calculating your 72(t) distributions. If your account earns less than your withdrawals, you may be forced to fund your 72(t) distributions by withdrawing your principal.

In addition, your selected asset allocation should coincide with your investment objectives and risk tolerance. Specifically, equity investments offer the potential for greater returns, but carry greater risk of loss in negative market cycles. If any of the investments in your account decline in value over an extended period, you are more likely to experience an accelerated decline in the value of your IRA assets. It is your responsibility to consider these risks carefully. Take the time to speak further with your Financial Advisor or Private Wealth Advisor if you have any questions or concerns regarding your investments and/or your current asset allocation.

72(t) distributions can be a viable option to provide current income before age 59½ depending on your circumstances. You need to consider your financial resources, needs and age, among other factors, before starting 72(t) distributions. Are you too young to start distributions? Do you have too little saved to start withdrawing from your IRA? Do you need these distributions now to cover your expenses? Will you feel comfortable taking these distributions for the required period? Do you have other options to meet your current income needs? The questions and answers below provide basic information about 72(t) distributions. 72(t) distributions must be structured properly in order to avoid the 10% premature distribution penalty tax. It is important to understand that Morgan Stanley Smith Barney LLC, its affiliates and Morgan Stanley's Financial Advisors and Private Wealth Advisors cannot give tax or legal advice. Before starting these distributions, you should consult with your tax and legal advisors.

WHO IS ELIGIBLE TO TAKE 72(t) DISTRIBUTIONS?

Any IRA owner can take 72(t) distributions at any time, for any reason. However, the strategy is intended to avoid the additional 10% tax on premature distributions, so it is only useful to those under age 59½ and don't meet another exception.

WHEN CAN I TAKE A 72(t) DISTRIBUTION FROM MY IRA?

You may begin at any age under 59½. However, you must set up a schedule of substantially equal payments (paid at least annually) that is calculated in accordance with IRS requirements and is based on your life or life expectancy (or the joint life or life expectancy of you and your beneficiary).

HOW LONG MUST THIS SCHEDULE OF SUBSTANTIALLY EQUAL PAYMENTS LAST?

72(t) distributions must continue for five years from the date of the first payment or until you reach age 59½, whichever is longer. For example, if you begin these distributions at the age of 56, you must continue through age 61. On the other hand, if you start receiving payments at age 48, you must continue through the age of 59½. The required distributions for each calendar year can be scheduled to be taken monthly, quarterly or annually.

HOW MUCH CAN I WITHDRAW?

Under the 72(t) distribution rules, you cannot just pick an amount of money you would like to take out of your IRA each year. Rather, you must use an approved method to calculate a stream of "substantially equal payments" to take place over the payment period.

The Internal Revenue Service has approved three methods of calculating the amount of these 72(t) distributions.

Required Minimum Distribution (RMD): Under this method, you divide your IRA balance for that year by the "life expectancy factor" found in an IRS Life Expectancy table, just as you would calculate your RMD beginning once you attain RMD Age[2]. Each year you recalculate your payment amount using any one of the three life expectancy tables found in IRS Publication 590-B, the Uniform Lifetime Table, Single Life Expectancy Table or Joint Life and Last Survivor Expectancy Table (with your eldest beneficiary).[3] Your account balance is determined as of December 31 of the prior year (subject to certain potential adjustments). Unlike RMDs you may not take more than the minimum amount.

Amortization: This method, based on a system commonly used in many mortgage repayment schedules, relies on your account balance[4], life expectancy (determined using one of three tables in IRS Publication 590-B[3]) and an interest rate that may not exceed the Permissible Interest Rate. For payments that commenced before 2023, the Permissible Interest Rate is 120% of the Federal mid-term rate for either of the two months immediately preceding the month in which payments begin (the "120%" rate), except that if the payments commence in 2022, the IRA owner may elect to use the IRS guidance applicable to payments that commence after 2022. For payments that commence after 2022, the Permissible Interest Rate is the greater of (i) 5% or (ii) the 120% rate. Distributions are then calculated as a stream of equal payments that will bring your account balance to zero at the end of the life-expectancy period. The annual amortization payment is calculated only once and used every year until 72(t) payments end.

Annuitization: The annual payment amount is determined by dividing the IRA balance[4] by an annuity factor that is the present value of an annuity of $1 per year beginning at the IRA owner's current age and continuing for life using the current account balance, the mortality tables or rates issued by the IRS in its published guidance or regulations, as applicable, and the interest rate described above for the amortization method. This amount is also calculated only once.

CAN I CHANGE THE CALCULATION METHOD AFTER I BEGIN DISTRIBUTIONS?

Yes, to change from the amortization or annuitization method to use the RMD method. You cannot change from the RMD method to either the amortization method or annuitization method, nor can you change from the amortization method to the annuitization method (or vice versa). For payments that commenced in a year prior to 2023 using the RMD method and the prior version of one of the life expectancy tables,[3] the IRA owner may elect a one-time change to the updated version of that same life expectancy table, without causing an impermissible modification to the 72(t) distributions and retroactive imposition of the 10% penalty tax, plus interest, on all 72(t) distributions taken prior to age 59½. Once you make this change, you may not make any other change. In general, any other change made after 72(t) distributions begin will subject you to the 10% tax penalty on all 72(t) distributions you have taken. In general, changes that can trigger the 10% penalty tax include (1) any additions to the IRA (other than investment gains or losses), (2) any transfer of a portion of the account balance to another IRA (though the IRS has made exceptions for certain transfers incident to a divorce), (3) a rollover of the 72(t) distribution resulting in the distributed amount not being taxed, (4) failing to take the full 72(t) distribution amount based on the 72(t) method and schedule chosen, or (5) any additional distributions that exceed the annual amount.

CAN I STOP RECEIVING IRA DISTRIBUTIONS BEFORE THE REQUIRED PERIOD?

You may stop your 72(t) distributions at any time. However, if 72(t) distributions are modified (including stopped) before the end of the required payment period, you will owe the 10% penalty tax, plus interest, on *all* distributions received up until age 59½. If you do not need all of the money being distributed to you, you cannot put the distributions back into your IRA but you are not obligated to spend these funds. You can deposit all or a portion of your 72(t) distributions into a savings or checking account or regular brokerage account for investment purposes.

WHAT IF MY IRA RUNS OUT OF MONEY BEFORE I COMPLETE 72(t) DISTRIBUTIONS?

Unexpected market downturns could cause your IRA to be exhausted before your 72(t) distributions have continued for five years from the date of the first payment or until you reach age 59½, whichever is longer. If this happens, you will not be liable for the 10% tax penalty but, more importantly, you may not have adequate funds remaining to support your retirement.

WHAT HAPPENS IF I DIE OR BECOME DISABLED DURING THE PERIOD WHEN I AM TAKING 72(t) DISTRIBUTIONS?

If you die or become disabled (as defined under the federal tax rules), the 72(t) distributions may be discontinued. These withdrawals will not be subject to the 10% premature distribution penalty tax, and the 72(t) distributions will have no impact on the way in which the funds remaining in your IRA are handled after your death.

IF I HAVE SEVERAL IRAS, DO I HAVE TO APPLY THE 72(t) CALCULATIONS TO ALL OF THEM?

No, in general, the 72(t) calculation is based on the IRA account from which you are taking the 72(t) distributions, leaving the funds in your other IRAs untouched.

CAN I TAKE 72(t) DISTRIBUTIONS FROM A ROTH IRA?

72(t) distributions can be taken from Roth IRAs in essentially the same manner as Traditional IRAs. However, since Roth IRA contributions can generally be withdrawn without incurring any income taxes or penalty taxes and Roth IRA distributions are always treated as consisting first of contributions, this strategy need only be used for a Roth IRA if you are under age 59½ and want to withdraw earnings (or certain converted amounts during the 5-year period for each conversion contribution) after exhausting contributions.

ARE 72(t) DISTRIBUTIONS RIGHT FOR YOU?

There are a variety of situations in which 72(t) distributions may be the right answer to your needs for current income. Providing an early retirement bridge is probably the most common use. You are retiring early, and you want additional current income. You have substantial assets in retirement accounts, and you would like to start using them. Some retirement plans let you begin withdrawing funds at the age of 55, while others have higher retirement ages or restrict distributions to lump sums. You can use 72(t) distributions as a source of income until you can begin using other retirement assets. Before beginning 72(t) distributions, you should consult with and rely on your own independent legal and tax advisors based on your particular facts and circumstances.

WHAT IS THE RIGHT AGE FOR STARTING 72(t) DISTRIBUTIONS?

An important part of the assessment of 72(t) distributions as an income alternative is your age. You can be too young or too old to benefit fully from this approach.

TOO YOUNG

If you are still in your early 40s or younger, you may be too young to derive real benefits from 72(t) distributions. First, you may not have accumulated enough money in an IRA. Second, the amount of the 72(t) distribution is calculated on the basis of your life expectancy, and if you are in your 40s, for example, your life expectancy is more than four decades. If your total IRA resources are limited, and if this sum ▶

has to be divided up over an extended life expectancy, you are not going to be able to generate much current income using 72(t) distributions. Moreover, you are choosing an expensive way to generate cash—you are using money that could otherwise be growing on a tax-deferred basis over the next several decades to provide for your retirement years. Instead of 72(t) distributions, consider other available options to meet your current income needs.

TOO OLD

If you are in your mid-50s to late-50s, you may also be better off finding a different income alternative than 72(t) distributions. These distributions must continue for at least five years from the date of the first payment, which forces you to remain on the 72(t) distribution schedule after you reach age 59½. If you do not elect a 72(t) distribution, you will have more flexibility once you reach age 59½—you can then take as much or as little as you like until age 72.[2] So if you are close to age 59½, it may be better to look at alternatives other than 72(t) distributions as a source of current income.

JUST RIGHT

Unfortunately, there is no age that is "just right" for starting 72(t) distributions. You need to calculate the penalty tax-free distributions and evaluate them in terms of your resources, financial needs, age and other financial alternatives.

Your Morgan Stanley Financial Advisor or Private Wealth Advisor has access to a tool, the LifeView 72(t) Distribution calculator, which can produce a free, no-obligation 72(t) analysis for you.

You should consult with your professional tax and legal advisors on these important and complex issues when reviewing the analysis.

[1] The premature distribution penalty-tax is 25% if distributions are made from a SIMPLE IRA in the first two years of participation in the employer's SIMPLE IRA plan.

[2] The SECURE 2.0 Act of 2022 increased RMD Age. RMD Age is (a) 70 1/2 (if born before July 1, 1949), (b) age 72 (if born after June 30, 1949, but before 1951), (c) age 73 (if born after 1950, but before 1960), or age 75 for all others - note, apparent drafting error in the SECURE 2.0 statutory language makes it unclear when age 75 starts to apply in lieu of age 73, but it appears age 75 is intended to apply if born after 1959.

[3] The IRS issued updated life expectancy tables (i.e., the Uniform Lifetime Table, the Single Lifetime Table and the Joint and Last Survivor Table) for purposes of calculating required minimum distributions (RMDs), starting in 2022. Subsequently, the IRS issued updated guidance applicable to section 72(t) distributions, which requires the updated life expectancy tables to be used for any series of payments that commence after 2022.

For payments that commenced in 2022, an IRA owner may rely on the prior IRS guidance, determining the 72(t) distributions based on the prior version of the life expectancy tables, or may elect to use the IRS guidance applicable to payments that commence after 2022 in which case the update life expectancy tables would be used to determine the 72(t) distributions.

For payments that commence in a year prior to 2023 using the RMD method and the prior version of one of the life expectancy tables, the IRA owner may elect a one-time change to the updated version of that same life expectancy table, without causing an impermissible modification to the 72(t) distributions and retroactive imposition of the 10% penalty tax, plus interest, on all 72(t) distributions taken prior to age 59½.

[4] For the amortization and annuitization methods, the account balance must be determined in a reasonable manner. Generally, if the account balance used to determine the 72(t) distributions is the account balance on any date from December 31st of the prior year to the date of the first distribution, the account balance will be treated as determined in a reasonable manner.

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