Avoiding 72(t) Mistakes in 5 Easy Steps

What are 72(t) payments?

72(t) payments are a series of substantially equal periodic payments made from an IRA that can be used to avoid the 10% penalty for early distributions. Payments must last the greater of 5 years or until the IRA owner reaches age 59 ½. When using a 72(t) schedule, a number of changes are prohibited. If these changes occur, the 10% penalty (and interest) is applied retroactively to all distributions made prior to age 59 ½.

 # 1 Separate your accounts first. When you establish a 72(t) payment plan, the distributions can be calculated using the balance(s) of one or more IRA accounts. But once the 72(t) schedule is in place, the rules significantly restrict your ability to make changes to the accounts without incurring penalties. So, split your IRA account(s) before you set up the plan. Leave only the minimum amount needed to produce your desired payment in accounts used to calculate the distributions.

 # 2 Make sure to wait a full 5 years. 72(t) payments must be maintained for at least 5 full years after the date of the first distribution. If you are taking distributions annually, this DOES NOT mean that after your fifth distribution, you're done. You must wait until the end of the fifth year before making any transactions that would result in a modification.

 # 3 Do not add to or subtract from accounts. Other than by the 72(t) distributions themselves, once a 72(t) payment plan is established, the account balance can only be changed by the earnings and losses within the account. NO additional contributions (including any rollovers or direct transfers) into the account may be made, and NO additional distributions can be taken.

 # 4 Try to avoid them. The 72(t) distribution rules are extremely restrictive and in most cases should only be used as a last resort. Before setting up these plans, be sure you've exhausted all of your other options. You may want to consider a home equity loan or check to see if your 401(k) or other plan offers a loan feature.

 # 5 No rollovers or conversions of payments. Sometimes financial circumstances change after the 72(t) payment schedule has been set up and the distributions are no longer needed. 72(t) payments cannot be rolled over into another (or the same) IRA and they cannot be converted to a Roth IRA. Instead, consider using the funds to start a "rainy day fund" in a non-retirement account in case another financial hardship occurs.

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