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YOUR PRACTICE | CASE STUDY

Making A Strong Connection with Telecom Employees

Helping early retirees tap into income from their retirement plans without incurring penalties

BY GINA BOLVIN BERNARDUCI

"How can I have almost a million bucks and feel broke?" asked Bob, one of my clients. He was sitting in my office contemplating an early-retirement offer from Verizon Communications. At age 54, Bob was offered a voluntary-retirement package, which included his savings from his 401(k) plan and a traditional pension plan. Under the pension plan, he could choose either a lump-sum payment or a pre-determined monthly payment over his lifetime. Bob preferred the lump sum option because he wanted to control his money, invest for the long-term and leave a legacy to his children.

However, one stumbling block with taking the lump sum was that Bob needed immediate income. While he could roll over his lump sum tax-free into an IRA, Bob was not yet at the magical age of 59½ that would allow him access to his retirement money without a 10% penalty. Many of my telecommunications clients and retirees face the same dilemma.

Fortunately, there are solutions. Often, early retirees are not aware of the steps they can take to tap income from their retirement plans before they reach 59½.

Working for many years with Verizon retirees, I have developed a game plan to help clients in this situation maximize their pre-retirement income.

Step-by-Step Planning

The first step is determining if the client will receive severance pay as part of their early-retirement package. In general, severance plans are scarcer today than in past years, but many employers still offer generous packages. Of course, the severance benefits vary. In this case Bob had almost 35 weeks of severance pay. While this income would support him through the first half-year of retirement, he would need additional income to cover nearly five years before he reached 59½.

The next step is to assess a client's non-retirement assets, including savings accounts, investment accounts and possibly stock options. These assets can provide a needed cushion to cover a retiree's income needs prior to age 59½. Given the short-term time horizon, these accounts should be managed conservatively to preserve capital and avoid market fluctuations. In Bob's case, he had minimal stock options and limited savings, so we had to look to other income alternatives to support him in the short-term.

The third step is to find out whether there is any post-tax money in the retiree's 401(k) account that can be withdrawn both tax and penalty free. While most 401(k) contributions are pre-tax, there are two ways that a 401(k) account can contain post-tax money.

First, money could have been contributed to a post-tax savings plan before it was converted into a 401(k) plan. Since Section 401(k) was implemented in 1978, and some companies were slow to convert to deferred compensation plans; some long-time employees may have post-tax money in the 401(k) plan account, and like Bob, may not know it. On the other hand, employees may have voluntarily, or even unknowingly, contributed additional post-tax money into their 401(k) account above the annual IRS pre-tax amount.

In Bob's case, he insisted that his 401(k) account contained only pre-tax money. But, further investigation revealed that he indeed had $38,000 in post-tax dollars in his 401(k) account. I recommended that he do an in-service withdrawal without suspension before he separated from the company. He received one check for $38,000 tax-free and the pre-tax amount was rolled over tax-free to an IRA. So far, the severance pay and post-tax amount from his 401(k) account would give him about a year-and- a-half in income but that still only brought him until age 55 ½.

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The last resort would be to tap retirement assets. Very few of my clients know about IRS tax code 72(t). If suitable, this rule allows distributions before age 59 ½ without the 10% penalty. But, here's the catch. You have to take substantially equal periodic payments for five years or until you're 59½—whichever is greater. And it's not flexible. I explained to Bob that he could start this at age 56 but would be locked into the same income for five years. If he needed more money, he would upset the 72(t) requirements and have to then pay the 10% penalty on all previous distributions. Bob then told me how much income he wanted. I informed him that, unfortunately, he doesn't determine the amount. The IRS dictates it. And, three formulas give three different amounts.

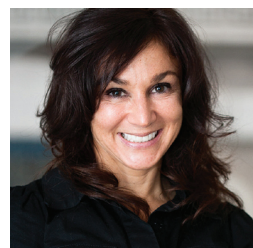
First, under the amortization method, payments are determined by amortizing the IRA balance over either the joint life expectancy of the IRA holder and a designated beneficiary or over the IRA holder's single life expectancy. A reasonable interest rate determined on the date payments begin must be used. With this calculation, Bob could receive $66,755 per year.

The second is the annuity method. It determines payments by dividing the IRA balance by an annuity factor, which is the present value of annuity of $1 per year, beginning at the individual's age attained in the first distribution year and continuing for that person's life. The factor must be derived using a reasonable mortality table and an interest rate that is reasonable on the day the payments commence. This method offered Bob $59,770 annually.

Finally, the required minimum distribution or RMD method determines the payment according to rules under Internal Revenue Code Section 401(a)(9). The annual payment for each year is determined by dividing the account balance by the number from the chosen life expectancy table for that year. Generally, payments may be based on one of the following criteria: the joint life expectancy of the IRA holder and a designated beneficiary; the IRA holder's single life expectancy; or the IRA holder's life expectancy based on the Uniform Lifetime Table. Under RMD, Bob could have received $36,598.

While Bob wanted the maximum income possible immediately, I discussed the need to balance his short-term income needs against his long-term retirement goals. I also advised him that when 72(t) income is added to earned income, it could potentially push him into a higher tax bracket. Because Bob wanted to find another job, tax implications needed to be considered.

This was the solution. He could take advantage of a one-time exception offered by the IRS that allows individuals using the amortization or annuitization methods to recalculate their distribution under the lowest formula—the RMD method. When Bob found a job, he could cut his 72(t) income, stay in the same tax bracket and continue tax-deferred growth of his IRA. He could choose the lump sum and obtain penalty-free income from his IRA while investing for long-term growth. By creating this plan, we satisfied his immediate need for income while building wealth for him and his family. **OWS**



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