

You may need a financial 'bridge' if you retire early

I'm not a civil engineer or an architect but today's column is about building bridges. In a financial planning context, this metaphor can explain how to get from a spot that may not be desirable to another that is more comfortable.

The recent economic climate has forced many people in their mid- to late-50s to decide whether to accept early retirement packages.

In many cases, these people are uncertain about the financial options and challenges presented by such an opportunity.



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In this case, many of them need to build an income bridge so they can afford their basic living costs between early retirement and future access to other retirement income sources including Social Security, pension or annuity assets, or a spouse's retirement.

Some people have accumulated enough savings outside of retirement accounts to build their bridge. For others, who have much of their life savings in Individual Retirement Accounts, building that bridge without penalty for withdrawing assets before age 59 1/2 is more complex.

In most cases, the IRS mandates a 10 percent penalty, on top of ordinary income taxes, for assets withdrawn from Traditional IRAs before 59 1/2.

However, there are several options for withdrawing IRA assets earlier without penalty.

The most important thing to consider here is whether short-term flexibility to access IRA assets is outweighed by damage to your financial security later in retirement. Dipping into IRA assets in your 50s should only be considered if there is no other option or if you're certain that the short-term benefits are more attractive than the long-term effects.

The IRS has identified four situations that will allow withdrawal from an IRA without penalties or special programs: Disability, payment of medical expenses in excess of 7.5 percent of adjusted-gross income, payment of insurance premiums for an individual health care policy after you've been on unemployment for 12 weeks, or qualifying higher education expenses for you, your kids or grandkids.

All of these options come with the caveat that the money withdrawn has to have been in the IRA for five years.

If you don't meet any of these situations and simply need to build a bridge to a future point where your retirement income will increase, there is another option that may be a smart financial planning tool.

Even without a qualifying reason to withdraw assets from your IRA before 59 1/2, you can do so without penalty ... if you follow the IRS rules. This program is called a Substantially Equal Periodic Payment (SEPP) plan.

Imagine hypothetically that you're 57, your employer offers an early retirement package that is attractive but doesn't fully cover your expected expenses. You believe that if you can tap your IRA for \$500 each month, you'll have enough to live well until Social Security eligibility, your spouse's retirement or whatever the next milestone financial event is.

You can design a periodic payment plan to withdraw the needed assets. The rule allows you to choose from three formulas for calculating your qualifying withdrawal. You don't have to include all of your IRA assets in the formula. You can customize the withdrawal strategy to be able to take just what you need, penalty free.

In exchange for the penalty-free opportunity, the IRS requires that you continue the periodic payment for at least five years or until age 59 1/2, whichever is later. If you start at 57, you must continue until 62. Start at 54 and you've got to continue to 59 1/2.

While assets withdrawn from a Traditional IRA via a SEPP avoid the 10 percent early withdrawal penalty, they are still subject to ordinary income tax. In order to receive the full benefit of the withdrawn dollars, it's best to pay the tax bill from other funds.

This retirement income bridge can also be built more simply from other types of retirement accounts. With an employer-sponsored retirement plan, (i.e., 401k), if you've separated from service from your employer after age 55 you can withdraw assets directly from your 401(k) without penalty or SEPP requirement.

Or, if you own a Roth IRA, where your contributions have already been taxed, you can withdraw assets equal to your contributions only any time after they have been in the account for five years, regardless of age.

As with any decision that impacts taxation you should consult a tax professional about your individual situation.

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