

Retirement Income before 59½

without early distribution tax penalties

Retirement plans – and the regulations surrounding them – are designed to encourage long-term saving and investment. While the Tax Code imposes a 10% penalty on early distributions from retirement accounts, it recognizes that you may need access to plan assets before 59½ – the age at which you can take penalty-free withdrawals.¹ That's where Internal Revenue Code Section 72(t) comes in. This section allows for penalty-free access to assets in IRAs and employer-sponsored retirement plans, provided you meet certain criteria. The substantially equal periodic payment exception, sometimes referred to as “72(t) distributions,” requires the following:²

- You must take a series of substantially equal periodic payments (at least annually).³
- You must continue taking the distributions – even if you no longer need them – for at least five years or until you reach age 59½, whichever is longer.
- While 72(t) distributions are not subject to the 10% penalty for early withdrawal, all applicable taxes on the distributions must still be paid in the year that they are withdrawn.
- You must generally be separated from service in order to take distributions from a qualified plan.

Substantially equal periodic payments are generally calculated using one of three IRS-approved methods commonly referred to as:

- required minimum distribution
- amortization
- annuity

Your financial advisor can help you determine which method is right for you.⁴

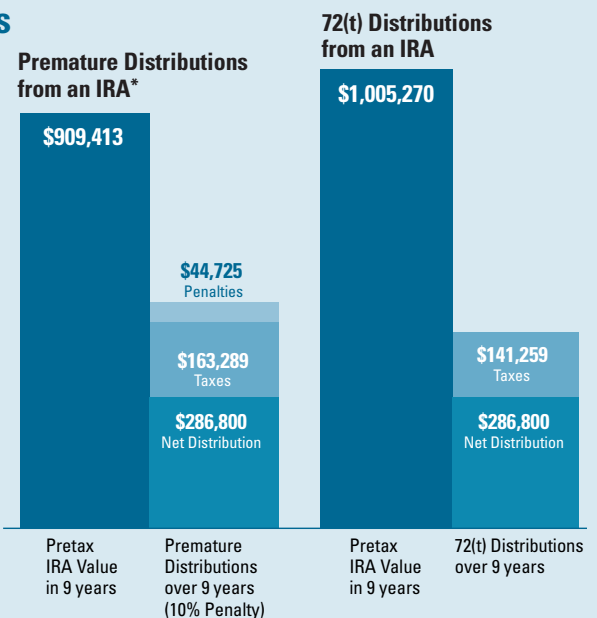
A hypothetical example to illustrate the possibilities

KEY ASSUMPTIONS

- A 52-year-old architect decides he wants to retire early and discusses his options with his financial advisor.
- Together they determine he will need to use his 401(k) assets for income during these early retirement years.
- The architect leaves his job and rolls over all of his 401(k) assets – \$800,000 – into a Rollover IRA.
- With his financial and tax advisors, he chooses the annuity method to calculate his substantially equal periodic payments. Based on his assets in the Rollover IRA and the applicable interest rate, he will need to withdraw \$47,562 pretax per year from his IRA under this method. Assuming a 33% combined federal and state income tax rate, this would result in net income of \$31,867 per year. If he took annual premature distributions instead, he would need to withdraw \$55,907 pretax each year to achieve the same net income because of the 10% penalty and the additional taxes on it.

THE RESULT OF TAKING 72(t) DISTRIBUTIONS

- The architect receives pretax 72(t) distributions of \$47,562 per year from his Rollover IRA for 9 years, until reaching 59½.
- He avoids the 10% early withdrawal penalty on his distributions – \$44,725 in this example.
- Even after his 72(t) distributions – totaling \$428,059 – the architect's initial \$800,000 rollover investment could grow to over \$1 million at the end of nine years, assuming an annual return of 8%.



The hypothetical example compares the effect of a series of substantially equal periodic payments (72(t) distributions) from an IRA, which are not subject to a 10% early distribution penalty, and annual premature distributions from an IRA, which are subject to the 10% penalty if the account holder is 59½ or younger. It assumes the following: The IRAs each had a pretax value of \$800,000 on 1/1 of the first distribution year. The annual rate of return for each IRA was 8%. All distributions were taken annually starting in the year the investor was 52 years old. The annuity method was used to calculate the 72(t) distributions for the second IRA. Based on IRS Revenue Ruling 2002-62, an annuity factor of 16.820 was calculated based on an annual interest rate of 4.60% compounded annually (120% of the federal midterm rate of 3.83% as of 2/07/05). The annuity method resulted in annual pretax distribution of \$47,562, which would be \$31,867 after taxes assuming a 33% combined federal and state income tax rate. In order to

reach the same after-tax amount, assuming the same 33% tax rate, annual premature distributions from the first IRA were \$55,907 pretax because of the 10% penalty and additional tax on penalty amount withdrawn.* The distribution schedule for the 72(t) distributions was not modified at any time. No additional contributions were made to either IRA, and no other distributions were taken from them. If the 72(t) distribution schedule was modified after establishment, other than a one-time switch to the required minimum distribution method, each 72(t) distribution would be subject to the 10% penalty on a retroactive basis. This hypothetical illustration is not intended to predict or project performance. Your own results will vary.

* In the ninth year, the premature distribution was only \$47,562 because the investor was assumed to be 59½ and not subject to the 10% penalty.

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THE VALUE OF AN ADVISOR. THE STRENGTH OF FIDELITY.

Potential next steps:

CREATE A REALISTIC RETIREMENT INCOME PLAN

As you think about leaving your job and withdrawing money from your retirement plan, you should reassess your overall plan. Set up an appointment with your advisor today to discuss all your financial issues.

CONSOLIDATE ASSETS AND SIMPLIFY RECORDS

Do you still have assets in former employer-sponsored retirement plans? Maybe you should consider rolling over all those assets into one Rollover IRA. Doing so may provide easier asset management and eliminate the confusion of multiple retirement statements.

We're here to help

With your advisor and Fidelity, you can be sure of having all you need to help take the uncertainty out of retirement income planning:

- One of the most knowledgeable and experienced firms in the retirement industry
- A full line of Fidelity Advisor mutual funds and IRA investment products
- Personal assistance of a financial advisor, whose expertise and dedicated interest you can rely on

You may want to consider using 72(t) distributions as a form of supplemental early retirement income in addition to other sources of income such as taxable accounts. Regardless of the 72(t) distribution method chosen, investors may find that the annual amount required to be withdrawn may be more or less than what they need. Additionally, you should be aware that making any modification to the series of payments, such as taking an additional distribution, or any modification to your account balance, such as a rollover, transfer, or contribution, will retroactively disqualify the series of payments. In the event that the series of payments is disqualified, the 10% early distribution penalty will be owed for each distribution in the series.

Additional planning options

AN ADVISOR CAN HELP YOU CHOOSE

TAKE A LOAN FROM YOUR EMPLOYER-SPONSORED RETIREMENT PLAN

Many plans offer this as a feature. It may allow you to borrow from your account balance and make repayments – including interest – back to your account on an after-tax basis. Loans of pretax monies must be paid back with after-tax monies, but such loan repayments are considered “pretax” monies in the account.

These loan repayments are usually deducted directly from your paycheck and invested directly into your retirement plan account. Talk with your financial advisor and review your plan documents for terms and conditions.

TAKE A PARTIAL DISTRIBUTION AND PAY THE 10% PENALTY

If you have a one-time income need, or you're in your 30s or 40s, and your plan allows for a 10% penalty on a partial distribution, it may be worth considering. Otherwise, you may be forced to take income you don't want over a long period of time and ultimately deplete your retirement account.

WAIT UNTIL YOU TURN 59½

When you turn 59½, you can simply begin taking distributions from your IRA (or employer-sponsored retirement plan, if the plan allows) without incurring a 10% penalty. (Remember, the taxable portion of a distribution is taxed as ordinary income in the year withdrawn.) If your assets are in an employer-sponsored retirement plan, you can generally take penalty-free distributions if you have separated from service at age 55 or later. If you're only a year or so away, this may be the smartest move.



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1. **Distributions from a retirement account before you reach age 59½ (or, for distributions from a qualified plan, before you reach age 55 and are separated from service) may be subject to a 10% early withdrawal penalty under Internal Revenue Code Section 72(t) in addition to any applicable income taxes on the distributions.**
 2. Internal Revenue Code Section 72(t) provides several exceptions to the 10% penalty on early distributions; however, this Insight focuses specifically on substantially equal periodic payments. Not all employer-sponsored retirement plans allow substantially equal periodic payments. Talk to your advisor and check your plan's documents to confirm whether 72(t) is permissible and to determine the terms and conditions of such distributions. Remember, if you do take these distributions, regular income taxes will apply.
 3. Substantially equal periodic payments are taken over your life expectancy or the life expectancy of you and your designated beneficiary.
 4. IRS Ruling 2002-62 allows taxpayers who select (or previously selected) the annuitization or amortization methods a one-time switch to the required minimum distribution (RMD) method. The annuitization and amortization methods result in fixed amounts being distributed each year, while the RMD method has variable distributions depending on the account value that may help prevent depletion of the account during down markets. This ruling also provides guidance on determining the interest rate to be used in calculating 72(t) distributions.
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