



# RULE 72(T)

## Using the 72(t) Rule for Early Retirement Income

*IRS exception can become a strategic advantage in your retirement strategy*

For many investors nearing retirement – or planning to exit the workforce earlier than expected – accessing retirement funds before age 59½ can present both opportunity and risk. The IRS's 72(t) rule, which permits penalty-free early withdrawals under specific conditions, may appear attractive.

However, from a financial advisor's standpoint, effectively utilizing Rule 72(t) requires foresight, planning, and careful execution.

### Reframing 72(t): From Lifeline to Strategic Lever

Often viewed as a last-resort solution for clients facing financial difficulty, Rule 72(t) can also be employed as a proactive planning tool for:

- Individuals seeking early retirement after a successful career
- Entrepreneurs in their 50s who have sold a business and need temporary income before Social Security or pension benefits begin
- Clients looking to bridge the income gap between early retirement and age 59½, without exhausting taxable accounts

When applied appropriately, Substantially Equal Periodic Payments (SEPPs) can deliver financial flexibility, income diversification, and long-term tax efficiency. The key lies in comprehensive modeling and strategic coordination.

### Strategic Planning Considerations

#### Tax Bracket Optimization

Tax efficiency is central to any retirement strategy. SEPPs offer an opportunity to “fill the bracket” by intentionally withdrawing funds at lower marginal tax rates during years of reduced income.

For instance, a client who retires at age 53 with limited income may use SEPPs to distribute IRA funds gradually. This can reduce future Required Minimum Distributions (RMDs) and help manage taxable income once Social Security or other benefits begin.

#### Preserving Portfolio Longevity

SEPPs involve fixed withdrawals based on a snapshot of the account value at the time of implementation. This introduces sequence-of-returns risk – particularly if the market underperforms in the early withdrawal years.

A segmented or “bucket” approach can help mitigate this risk:

- Short-term (1–5 years): Allocated to conservative investments, such as cash equivalents or short-duration bonds, to support early withdrawals
- Long-term (5+ years): Allocated to growth assets intended to replenish the portfolio and combat inflation

This strategy supports both near-term income stability and long-term capital preservation.

## Key Risks Clients May Overlook

### Rigidity and Penalty Exposure

SEPPs are inherently inflexible. If a client modifies, increases, decreases, or stops payments before the required term ends – five years or age 59½, whichever is longer – all prior withdrawals become subject to the 10 percent early withdrawal penalty retroactively.

Clients must understand that unexpected changes such as returning to work, health emergencies, or needing additional income do not exempt them from the SEPP obligations.

### Emotional Investing Behavior

Early retirees withdrawing from retirement accounts may become susceptible to market-driven anxiety. A decline in portfolio value could prompt impulsive decisions, such as altering asset allocations or terminating the SEPP, which may result in adverse tax consequences or financial setbacks.

To reduce behavioral risk, advisors should implement a clear investment policy statement (IPS) and maintain ongoing communication with clients throughout the SEPP period.

## Case Study: Applying SEPPs in a Thoughtful Retirement Strategy

**Client Profile:** Amy, age 54, recently sold her business and holds \$1.2 million in a traditional IRA. She wishes to generate \$60,000 annually in retirement income and delay claiming Social Security until age 67.

### Strategy:

- A SEPP plan is established using the amortization method to generate \$60,000 annually for the next five and a half years.
- Emergency and discretionary funds are held in a separate brokerage account to maintain liquidity and avoid disrupting the SEPP.

- The SEPP portfolio is structured with a conservative/moderate allocation and includes a bond ladder to support withdrawals through the initial period.

**Outcome:** Amy avoids the 10 percent early withdrawal penalty, stays within a favorable tax bracket, and maintains long-term financial sustainability.

## Evaluating More Flexible Alternatives

Before committing to a 72(t) plan, financial advisors should guide clients through other potential strategies:

- Withdrawing contributions from a Roth IRA (tax- and penalty-free)
- Utilizing 401(k) withdrawals after age 55 if separated from service
- Taking a 401(k) loan, if permitted by the plan sponsor
- Drawing from taxable brokerage accounts, which offer flexibility and capital gains tax treatment

Rule 72(t) should be used as part of a larger, integrated retirement income strategy – not in isolation.

## Advisor's SEPP Readiness Checklist

- Have cash flows and tax impacts been modeled for the SEPP period?
- Are sufficient emergency reserves held outside the retirement account?
- Has the most suitable SEPP method been chosen to meet the client's needs?
- Is the portfolio appropriately structured to support ongoing withdrawals?
- Have all potential risks and limitations been reviewed with the client and properly documented?

## Final Thought: Treat Rule 72(t) Like a Scalpel, Not a Hammer

From a fiduciary perspective, Rule 72(t) is not a blunt instrument – it is a precision tool. When thoughtfully applied, it allows financial advisors to help clients bridge retirement income gaps without compromising their long-term security.

Whether Rule 72(t) is the right fit depends on the client's broader financial circumstances, risk profile, and retirement goals. With a disciplined plan and proactive guidance, this IRS exception can become a strategic advantage in a well-rounded retirement strategy.