What's With 72t?

Frederick Rosenberg

Overview of the Problem

Over my 30 plus years of investment related practice, 72t claims - cases arising when mid-level employees are induced into accepting early retirement buyouts - head the list of *genuinely tragic abuses***.** These cases abound within the utilities and telecom industries, where corporate consolidations were accompanied by generous “buyout offers” to employees with long service.

The Claimant will typically be a line supervisor living modestly in rural America who worked for the local phone company since high school and 30 years later was doing relatively well earning 45-60k/year. Then Bingo! Good fortune strikes in the form of an offer of early retirement. At age 50, the Claimant is offered the choice of a guaranteed annuity or a lump-sum distribution of his Defined Pension Benefit that could be rolled-up with a 401K and any ESOP shares into an IRA.

In my experience, the typical rollover averages $350,000, a modest amount by brokerage standards but a relative fortune to these wage earners. And, because these people have never invested on their own, they are “investor-virgins”, susceptible to being taken advantage of. It’s pretty bad when 72t is used as an instrument to pry risk capital out of vulnerable early-retirees.

Early Retirees unquestionably expect and require a reliable monthly income from their rollover proceeds. If an annuity were elected, the benefits while guaranteed, ended at death. If an IRA rollover were elected, the retiree faced the daunting task of having to invest the lump sum to support a life expectancy of 35 years. Unfortunately, the lump-sum option offers no protections or guarantees, a problem that by all measures puts the entire fortune at serious risk. Additionally, since early liquidations carry a 10% penalty on each withdrawal amount, retirees must take distributions that meet the definition of “substantially equal periodic payments” - that is spelled out under 72(t)(2)(A)(iv) - or pay the penalty.

As an overview, if I were asked to summarize the problems with 72t situations it would go like this:

1. The problem with 72t cases begins with the Broker's illustrations, which offer a choice of only three distribution scenarios, instead of the broad matrix of distribution possibilities at all risk levels. The broker's illustrations, which most customers interpret, erroneously, as being the only scenarios permitted by the IRS, typically are the highest risk scenarios common with growth stocks. Without illustrating withdrawals over an entire range of volatilities, the customer is misled about his or her choices.

2. Virtually all illustrations and projections ignore volatility(risk). Therefore, growth projections typically illustrate riskless straight-line growth rates found only in certificates of deposits instead of the true high-volatility market characteristics of the broker's higher risk recommendations. Worse, the broker in his defense will allege that these misleading illustrations are somehow required by law under 72T.

3. Adverse outcomes are never illustrated at all but are merely disclaimed and footnoted.

4. The interest rate used to calculate the "payment amount" is also utilized to illustrate growth forecasts (despite the fact that the actual recommended portfolio is monumentally riskier than the zero volatility CD rate of the illustrations).

5. The customer does not understand that the investment mix and risk characteristics of their IRA portfolio under 72T can be changed without penalty. Instead most believe the originally investments selected can never be changed without incurring onerous penalties under 72T.

6. The broker never computes and illustrates the actual penalties, which in early years can be quite minimal, leaving the customer unnecessarily terrorized by the fear of triggering an "IRS audit".

7. Regular distributions cannot safely be accomplished with growth stocks. If fees, expenses and withdrawals exceed 5%-6% of original principal invested in growth stocks, there is a 50/50 likelihood that the account will be fully depleted in 20 years.

Eroding Principal to Meet 72t Mandates

By early 2000, the seeming ability to earn 25% annually in the S&P500 simply made achieving an 8% return a "no-brainer" in the minds of brokers chasing down these "Buyout Boomers". The usual pitch was that an annuity grows at only 3-4%/year, a rate brokers believed could be safely doubled in the market (i.e., "Irrational Exuberance").

In lieu of the annuity, brokers promised "peace of mind", a lifetime income and an estate that was conservatively achievable from portfolios comprised principally of volatile growth stocks. If withdrawal rates are limited to 2-3%/year, that goal *is* reasonably achievable, but with 6-8% withdrawal rates the representation is grossly reckless and negligent even when made in good faith. Within a few years time most early retirees often begin invading their principal to meet the mandatory 72t withdrawals thereby preventing their portfolio from generating the return needed to sustain their retirement.

The rationale behind growth investing is the general market bias *upwards* over the long-term. By *holding* volatile growth stocks (not liquidating them), an investor's long-term probability of profitability is greatest. Statistically, this is known as "Regression to the Mean", the certainty that in the long run, it all averages out. Liquidating shares monthly to generate regular income simply undermines a growth strategy leaving the investor with the worst of all possible worlds, a current income strategy with all the short- term risk characteristics of high volatility growth stocks. If you step back and think about it, it's oxymoronic.

One simply cannot withdraw 6-10%/yr plus fees and costs and expect *any* growth portfolio to appreciate continually over a 35 year life expectancy. Regular liquidations also throw off the portfolio balance in volatile markets because disproportionate shares are liquidated to generate a fixed dollar amount (or fixed percentage of the portfolio). More shares are sold when a mutual fund declines, shares that are no longer available to participate in any future recovery. Selling appreciated shares violates the long-held principle of growth investing, "letting profits run", and undermines the compounding needed to smooth over the dips and market corrections endemic to volatile markets. Mandatory 72t withdrawals are blind to that reality.

Most authorities recognize that if fees, expenses, and withdrawals exceed 5-6%/yr, there is a 30%-40% probability that a growth stock portfolio will be fully depleted in 20 years or less under normal market conditions. Most retirees would never accept that risk if they were so informed prior to taking early retirement. Yet brokers in 72t cases routinely bless withdrawal rates of well over 8% when prying "risk capital" out of generally unsophisticated early-retirees. And their firms turn a blind eye to such conduct, even with warnings contained in NASD Notices to Members.

Typical Cases

In the72t cases I see, the Claimants are characteristically pitched by brokers who:

1. Misrepresented the risk of their investment strategies by recommending growth stocks to fund regular withdrawals,
2. Gave negligent legal advice,
3. Used misleading forecasts erroneously attributed to the IRS, and
4. Failed to disclose the impact of fees.

As a class, 72t Claimants typically have been persuaded to adopt investment strategies that have little or no possibility of meeting their long-term objectives. What stands out in every case I see is that none of the investors ever had the benefit of independent counsel or the unbiased advice of an independent specialist. Each, often with the encouragement of their employer, attorney, or accountant, adopted a potentially fatal investment strategy based upon an overly optimistic sales pitch. Each client executed agreements apparently unconcerned about the undisclosed conflicts of interests, risks and breaches of fiduciary responsibility that placed the broker's interests above their own.

In virtually every case, the Claimant's account was partially or completely automated, with liquidations occurring on a schedule and distributions transferred directly into checking accounts.

Sales of mutual fund shares were automatically processed through liquidation programs so that monthly share liquidations occurred without need of customer approval. Month after month the Claimants saw that "income" was received in their checking account, distributions characterized continually by the broker as "income", reinforced by statements that blurred much of the differences between brokerage and banking. Claimants were encouraged by their broker to spend this money, to enjoy their early retirement without giving a thought of returning to work.

Why 72t?

Under the IRS Code, all 401(k), IRA, pension and retirement plan participants suffer IRS penalties for early withdrawals. However, under 72(t)(2)(A)(iv), the penalty is waived for withdrawals that meet the test of being "substantially equal periodic payments". The definitions of "substantially equal periodic payments" under 72(t)(2)(A)(iv) are published in the infamous IRS Notice 89-25[1]

Understand that the IRS is making it possible for hardship cases to withdraw periodic payments from their IRA without penalty, so long as the original tax-policy was not undermined (e.g., providing lifelong retirement savings via tax-deferred growth, and tax deductibility). The authors of the Code wanted to assure that those who took 72T withdrawals would at least sustain their actuarial lifespan without defeating the law through higher growth rates that would prematurely drain accounts.

Approved Withdrawal Methods

Section 72t authorizes one of three approved methodologies to compute an acceptable withdrawal amount. The first method was to simply divide the outstanding balance by the last actuarial year- if the customer has 36 years on the table his annual withdrawal would be 1/36th, then 1/35th, then 1/34th and so on. There is no implied interest rate needed to compute a withdrawal amount. The Full Amortization Method and Actuarial Method, the two remaining

[1] Exhibit 1

methodologies, calculate withdrawal amounts by formulae based upon amortizing the principal fully over an investor's actuarial life.

The Full Amortization method is the one most commonly selected by investors and brokers. Basically, the customer's assets are viewed as self-liquidating, like a mortgage note. The principal amount is amortized over the person's life expectancy; say 30 years at an interest rate that is capped at 120% of the AFR, a rate published by the Treasury (although prior to 2002, the interest rate was defined as "reasonable").

To determine the annual payment at an 8% amortization rate, use the Excel Pay function and enter a principal value ($350,000), 360 monthly payments, and a 0.66%/month interest rate (8%/12) to determine the payment. The Actuarial method generally gives results near to the Amortization method's results. I'm not an actuary, but I assure you that they have a formula based upon life expectancy and a reasonable liquidation rates.

You'll note from these calculations that the payment you calculated *exceeds* the interest rate used. That is because Amortization also includes a return of principal. Thus, under the Amortization method, an 8% rate results in a constant of 8.75% of the principal contribution, exactly like a mortgage. This is important because the investor is likely to be given an illustration of only 5-8 years that omits the full amortization schedule. Remember that in most cases, the customer is motivated by promises of an estate at life's end. But, regardless of the 72t methodology elected, a full amortization schedule would disclose declining principal balances throughout the customer's retirement that, by the end of his life expectancy, will fully extinguish the account.

72t Is Not A License To Commit Securities Fraud

Nowhere in the IRS Code or Regulations exists an authorization, instruction or guide for providing illustrations or forecasts. Unfortunately, the brokerage industry often represents, erroneously, that it must utilize the interest rate used to calculate the "payment amount" to illustrate growth forecasts. This is simply false!

Even knowing full well that the actual portfolio they're recommending is monumentally riskier than the zero volatility CD rate of their illustrations, brokers are encouraged and often required to use their erroneous forecasts on bogus " IRS legal grounds". If the broker does not intend to use a guaranteed fixed-rate investment, his use of an illustration assuming a riskless growth rate is tantamount to fraud when the investor's funds are placed at the mercy of the market.

Customers Often Misled Regarding Lower Withdrawal Options

Another significant issue that typically surfaces in 72t cases occurs when the customer is asked how much he needs to live on, and the broker then backs into a withdrawal rate. Instead, the broker ought clearly indicate to the customer that withdrawals greater than 4% of original principal, including fees and expenses, should be the *upper limit of annual distributions* unless the customer is willing to risk destitution during retirement. Use of 6% to 8% withdrawal rates without full disclosure of risk is negligence and perhaps recklessness.

Most commonly, illustrations are limited to that single withdrawal rate, leaving the investor totally unaware that there are lower withdrawals amounts available under 72t. Without illustrations of all possible withdrawals across a matrix of possbilites, the customer is mislead to the conclusion that the withdrawal amounts shown are the only alternatives per IRS regulation.

What Most Investors Hope

Most investors opting for 72t are early retirement-buyout candidates looking for a safe way to bridge the gap to social security and to arrive at full retirement with their estate intact. Most are willing to invade principal *a bit* before social security kicks in, as most illustrations show. This makes the 72t investor primarily a short-term investor. Yet, virtually all of these cases park the customer in high volatility long-term growth portfolios totally incapable of giving the safety suggested in the illustration. As the recent market crash illustrates, you cannot manage the short term volatility of growth stocks even through broad diversification and especially for accounts under regular 72T withdrawals.

The determining factor in retirement cases is *the rate of liquidation.* At 8% annual withdrawals, a growth portfolio can reasonably be expected to last between 12 and 20 years under normal market conditions. At 4% withdrawals, that period nearly doubles. Withdrawal rates *greater* than 10% have a probability of lasting 8 to 15 years tops and only extended periods of extraordinary market performance can increase that depletion expectancy.

The gravest investment recommendation is to utilize Growth Stocks based solely on longevity expectations. Longer life expectancy simply does not justify using growth stocks, the highest volatility category of securities, unless distributions will not be necessary for at least two market cycles, perhaps 12-15 years. The fact that the life expectancy of many early retirees is 30 or more years does not justify using growth stocks when withdrawals are expected to exceed 4%/year. Furthermore, increasing portfolio volatility to achieve the higher returns needed to support excessive withdrawals actually reduces returns in most cases and shortens the time to full depletion.

Handcuffs?

72t, to the dismay of some, is pretty unforgiving and breaking the withdrawal invokes a 10% penalty plus interest. Once a withdrawal method is selected, it cannot be changed, until the greater of age 59 1/2 or 5 years.2 While after 2002 the investor can change the methodology to forestall the depletion of his account, rarely will a new investor need to change the methodology today.

Take the Poison? It May Not Kill You

Most Claimants erroneously believed their investments could *never* be changed, rebalanced or modified without substantial penalty or without triggering an audit. The problem that most

[2] Exhibit 3: In 2002, the IRS established a safe harbor to permit a change in the withdrawal methodology coupled with a reduced penalty on the difference between what was withdrawn vs. what would have been withdrawn under the new methodology.

investors face is that they don't understand the consequences of taking the poison. In fact, most believe they are obligated under federal law and IRS Regulations to an unchangeable course once their investment decisions are made. What they are never shown by the broker is an illustration of the costs of breaking their 72t election. Often the penalty, 10% of the actual distributions plus interest, is not onerous, especially when compared with the effect of continued withdrawals under 72t.

Sometimes it is simply preferable to pay the penalty. This puts a premium on moving quickly to avoid accruing penalties. Consequently, competent advice can only be based on knowing the amount of the penalty. The broker needs to be aware, for example, that the penalty for breaking a $3,000 monthly withdrawal after a year under 72t is $3,600+/- or a little more than one month's withdrawals. Arguably, the loss of one months income is a very reasonable cost to staunch the hemorrhaging; had the customer been properly advised, he or she would likely have paid the penalty.

Are Fees Considered in Illustrations? They Should Be

If the customer accounts are fee-based and the 72t illustrations do not account for the fees, you need to run the identical illustration to show the fee's impact over the investors' expected life. A 1% fee will shorten payouts from 36 to 29 years in most illustrations, and 2% fees will further shorten payouts to 24-26 years. For a retiree expecting 36 years of "income", the fees alone often doom those expectations.

Failure to illustrate the impact of fees over the long term is clearly a deception at worst and negligence at best. In breach of fiduciary duty cases, failure to illustrate the fees' impact would likely constitute a material misrepresentation, particularly for Registered Investment Advisors (RIA). Remember, there is no language in the federal or IRS rules that even mentions illustrations. The mere fact that one interest rate is used to compute a payment under the 72t formulae does not license Respondents to mislead the customer about risk, especially given the long-term corrosive impact of fees. The best advice? Do it right or don't use illustrations at all.

Don’t Roll It All In

Another issue with 72t that I frequently see is that upon retirement, the investor has several sources of funds: Pension Buyouts, ESOP shares and 401(k)’s in various amounts, yet all of them are rolled over into the IRA. However, many investors at early retirement have no income whatsoever; their tax rates are virtually zero; and, distributions derived from retirement accounts, while taxable, are not subject to FICA’s 7% withholding.

By disaggregating the lump-sum into its constituent accounts, the client might be better off by holding out one of the constituent accounts to specifically fund intermediate term needs, albeit with penalties for early withdrawal. This strategy is more conducive to growth investing, as the rolled over accounts could be allowed to grow free of the damaging impact that regular withdrawals impose on growth portfolios.

For example, with $350,000 that can be invested, $200,000 could be rolled into an IRA and invested in a balanced portfolio of value stocks and bonds, with the remaining $150,000 used to meet living needs over the intermediate term, 5-7 years, until social security kicks in. At average 6-7% growth, the $200,000 account could be expected to grow tax deferred to $350,000 in less than 7-8 years, equaling the original investment, during which period the $150,000 would be fully depleted at 20,000/year after 7 years.

Furthermore, without mandatory withdrawals, the investor has the flexibility of deferring withdrawals into subsequent years. And while normal penalties disappear at age 59 ½, under 72t, those penalties continue for at least five years *regardless of age*. The closer in age the investor is to 59 ½, the more burdensome becomes 72t.

Damages in 72t Cases

There is no greater evidence of income objectives than IRAs distributing regular monthly amounts under 72t election. Yet many new account forms still list long-term growth as the customer's principle objective. Arguably no IRA distributing under 72t could be categorized as anything other than an income account and supervisors reviewing these accounts owe a duty to the customer to ensure that the investor is well versed in risk.

In most 72t cases, the investor is induced to surrender a guaranteed annuity in exchange for a portfolio of stocks that are represented to be fully capable of sustaining lifetime distributions equal to or greater than the annuity, while maintaining principal sufficient to generate those distributions and create an estate to pass on at death.

For months, if not years, the customer and broker treat withdrawals exactly like income, initially lulled into a false sense of security. The client is typically able to notice the decline in principal value but is uniformly advised to hold on. What the client often loses sight of is the impact of liquidating shares to the point that there are simply insufficient shares to produce distributions in the out years.

Ironically, when claims are brought against the broker, all those years of income are suddenly recast as a "return of principal" to support bogus "Net-Out-of-Pocket" analyses that effectively cheat the injured customers out of the very income they were promised. It is manifestly unjust, therefore, for brokers who promise, report and distribute "income" to 72t investors to then plead in arbitration that the distributions were not income at all but returned principal.

Arbitration panels must come to understand that 72t cases deserve special consideration in making the customer whole. If the panel determines to treat distributions as "principal", it should award lost income. Conversely, were the panel to determine that the Claimant's distributions were "income", (effectively estopping Respondents from denying that fact), it should recognize lost principal as the damages.

Conclusion

In conclusion, 72t is no panacea for retirees, but for brokers it has become a proven tool to drive business. Those who are persuaded to adopt 72t solutions for early retirement are principally wage earners employed by large corporations who live in Company Towns. These wage earners can read their statements and often perceive the erosion in their principal, but are clueless as to why, especially when they continue to receive their promised regular distributions. It is fair to conclude that no retiree would have ever taken the buyout had he or she understood that their withdrawals required depletion of their principal.

A retiree's objectives can often be met conservatively without the limitations imposed under 72t, even after penalties. More problematic, however, is that 72t has been used to thoroughly misrepresent the risks of taking regular distributions out of a retirement portfolio comprised of growth stocks. Outside of their 401k, most of these wage earners have scant experience with investments and none ever consults with independent counsel when committing their entire life savings to a program pitched by a commissioned salesman. Neither should they be held to levels of sophistication that even their brokers fail to achieve.

Panels clearly must to look beyond NOPs to restore both lost principal and lost income to these Claimants, who, but for the promise of income and savings, would have continued to work, at worst, or, at best, reduced their lifestyle to conform to lower income expectations.