

## **Part X Early Retirement**

---

### **Early Retirement and Savings**

Perhaps the biggest difficulty involved with early retirement is that it leaves savers with less time to save. People who wait until the traditional retirement age of 65 and avoid long spells of unemployment along the way likely have careers at least 40 to 45 years in length. That long career is the best weapon most retirement savers have.

Not only does early retirement cut short the years to save, but it also cuts short one's years of earning income. Consequently, early retirees will need to save more than those who wait to age 65 or later. This is the only way to make up for the shorter career and to finance a longer retirement.

### **Early Retirement and Penalties**

Other major sources of retirement income, such as Social Security and pension benefits, will also be reduced if one retires early. Retiring prior to full retirement age is likely to reduce one's monthly Social Security benefits in two ways:

- Early retirement penalty
- Fewer high earnings years might mean lower Social Security benefits

The typical defined-benefit defines the size of its benefits based upon the following factors:

- The number of years that one spends with the firm
- One's peak salary with the firm
- One's age at which he begins to receive his benefits. There is a penalty for starting prior to age 65

Pension plan rules vary, but early retirement almost always has a very substantial negative impact on a defined-benefit pension.

In general early retirement will have a less dramatic effect on Individual Retirement Accounts and defined-contribution pension plans, such as 401(k)s, than it does on defined-benefit retirement plans. But retiring early will restrict the time one has to save for retirement with these plans. Tapping them can lead to high penalties, also.

### ***Avoiding Early Withdrawal Penalties***

Previously, the only way to use funds from an IRA without the 10% premature distribution penalty was death or total disability before age 59-1/2 – choices that are not at the top of one's list. One can still use the 60 day IRA rollover to avoid the penalty for company pension/401(k) distributions and between IRAs. But if one's financial and personal objectives prior to age 59-1/2 are longer than 60 days, then one was out of luck.

The Tax Reform Act of 1986 added another exemption to the premature distribution penalty tax with Internal Revenue Code Section 72(t)(2)(A)(iv) referred to as 72(t). Generally, the exception permits individuals to take "substantially equal periodic payments". Therefore, we now have more freedom prior to age 59-1/2 to consider:

- early retirement offers from company's restructuring
- career changes to start a new business or obtain more schooling
- funding college education, supporting elderly parents or other financial needs

Originally the new exemption wasn't very useful because there were many gray areas regarding how to establish these payments. We now have guidance from the IRS (notice 89-25) so one can use his IRA to retire early, start a new business, etc. Of course, both Federal and State taxes are still due, but the penalty tax is avoided.

The exemption is really only practical for people in their late 40's & 50's. After 59-1/2 there is no penalty. For younger individuals the IRA balances are generally small and distributions would have to continue until age 59-1/2. Once one starts the distributions under the 72(t) exemption they must continue for at least 5 years or until age 59-1/2, whichever is longer. In other words, if a 30 year old begins distributions, they must continue for almost 30 years (i.e., until reaching age 59-1/2). On the other hand, if a 58 year old begins distributions, they must continue at least until age 62 (i.e., for at least five years).

## **Early Retirement and Medical Coverage**

One living expense of particular concern to early retirees is medical insurance. While Medicare provides substantial—although by no means total—medical coverage for retirees, it is not available until one reaches age 65. It is important that those considering early retirement also consider their health insurance options prior to leaving their current employer. For those who retire prior to age 65, there are a number of health insurance options:

- Stay on one's employer's plan if possible
- Extend one's current benefits under COBRA
- Convert one's company policy to an individual policy
- Look into group policies available through organizations or associations to which one belongs or could join
- Find an individual policy

## **Early Retirement and Success**

- Trim one's pre retirement budget. The best way to amass the funds one will need for early retirement is to make saving a top priority. If one is not willing to make a few sacrifices, then early retirement might not be a realistic goal.
- Invest for growth. If one is not going to be earning money for the last thirty or so years of his life, his money should be making some money.
- Consider working part-time after retirement.