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Publications

IRS Updates Safe Harbor Methods for "Substantially Equal Periodic Payment" Exception

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Recent IRS Notice 2022-6 updates longstanding guidance on when a series of payments from an individual account under a tax-favored retirement plan is considered a series of "substantially equal periodic payments". Under Code Section 72(t), taxpayers who choose to make an early withdrawal (which generally applies to withdrawals before age 59½) from their IRA, 403(b), or qualified plan may be subject to an additional 10% income tax on the amount distributed. However, Section 72(t)(2)(A)(iv) exempts distributions that are part of a series of "substantially equal periodic payments" over the taxpayer's life expectancy (or joint life expectancy with a beneficiary).

We summarize the new guidance (which also applies to nonqualified annuities under section 72(q)) below.

Background

In 1989, the IRS provided three safe harbor methods for satisfying the "substantially equal" requirement (Notice 89-25, Q&A 12). Two of the safe harbors result in a fixed amount that is required to be distributed each year, which, unfortunately, results in a premature depletion of taxpayers' retirement savings in declining markets. In Revenue Ruling 2002-62, the IRS announced a one-time allowance to switch from either of these two fixed methods to the safe-harbor method that varies the distribution based on the annual account value, called the required minimum distribution ("RMD") method. The RMD method calculates the annual payment for each distribution year by the number of years from the chosen life expectancy table, now included in Section 3.02(a) of Notice 2022-6. This redetermination of the annual payment is not considered a "modification" of the series of substantially equal periodic payments, provided that the taxpayer continues to use the RMD method and the same life expectancy tables.

Guidance

The new guidance updates the life expectancy tables that can be used to determine distribution periods under the RMD method: (1) the Uniform Lifetime Table in Appendix A of Notice 2022-6; (2) the Single Life Table in § 1.401(a)(9)-9(b); or (3) the Joint and Last Survivor Table in § 1.401(a)(9)-9(d). The IRS updated the distribution tables (including the Uniform Lifetime Table as incorporated) for improved life expectancies in December 2020, requiring that they be used to calculate required minimum distributions on and after January 1, 2022. We understand, however, that Notice 2022-6 provides flexibility as to when the new tables must be implemented, meaning that in some cases, required minimum distributions may effectively continue to be paid under the old tables. Specifically,

- for a person under 70.5/72 (as applicable) who was in pay status pre-2022, the old tables may continue to be used to calculate the RMD option,
- if payments commence in 2022, the old tables or the new tables may be used,
- if payments commence in 2023, the new tables must be used for the relief,
- and, if payments started under the old tables per first two scenarios above, a change to the new tables is allowed on one-time basis in any later year without losing the relief.

Also, in the case of a series of payments commencing in a year prior to 2023 using the RMD method, if the payments in the series are calculated by substituting the Single Life Table, the Joint and Last Survivor Table, or the Uniform Lifetime Table for the corresponding table that was used in Rev. Rul. 2002-62, then the substitution is not treated as a "modification" within the meaning of Section 72(t)(4) or Section 72(q)(3).

The new guidance also clarifies that a taxpayer who begins distributions using a safe harbor method other than the RMD method is permitted in any subsequent distribution year to switch to the RMD method to determine the payment for the distribution year of the switch and all subsequent distribution years. This first change will not be treated as a "modification" within the meaning of Section 72(t)(4).

Finally, the guidance modifies the interest rate to be used under the fixed amortization method or the fixed annuitization method to a rate not more than the greater of (i) 5% or (ii) 120% of the federal mid-term rate. Prior guidance did not include the 5% rate.

Next Steps

We expect the primary impact of this relief will be in the IRA and 403(b) markets, although participants in qualified plans may be affected too. Plan sponsors and recordkeepers should implement these changes, choosing among the available compliance options – and consider whether to affirmatively notify current account holders receiving payments before age 59½ of the opportunity to modify the distribution stream.

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