

# Series of Substantially Equal Period Payments for Life or Life Expectancy

Navigating the SOSEPP rules

## Background

Taxable distributions from individual retirement accounts (IRAs), qualified plans, similar retirement accounts such as 403(b) annuities, and nonqualified annuities before the owner's age 59½ are usually subject to an additional 10% tax.<sup>1</sup> This tax is often referred to as the 10% early withdrawal penalty.

There are exceptions to this penalty for each type of account. While the exceptions are not identical for each account type, there is one common exception for distributions which occur as a series of substantially equal periodic payments over the life or life expectancy of the taxpayer – often referred to as a “SOSEPP.”

## SOSEPP for life

The distributions must be calculated as a series of substantially equal periodic payments *over life or life expectancy*. For example, if a taxpayer owns an IRA or nonqualified annuity for several years and then at age 55 begins a ten-year annuitization to age 65, the payments might be substantially equal, but they have not been designed to endure *for life*. These payments would not meet the exception.

## Three SOSEPP methods

The IRS provides three methods for calculating SOSEPP distributions.<sup>2</sup>

### 1. Required Minimum Distribution (RMD) Method

The annual payment for each year is determined by dividing the account balance by the owner's life expectancy, taken from one of three tables issued by the IRS: the Single Life Table [Appendix A], an expanded Uniform Lifetime Table [Appendix B], or the Joint and Last Survivor Table [Treas. Reg. § 1.401(a)(9)-9(d)]. While the annual payments are redetermined each year, any resulting fluctuation in the amount of the payment is not a modification of the SOSEPP.

### 2. Fixed Amortization Method

The annual payment is determined by amortizing the account balance in level amounts over the owner's life expectancy (or joint life expectancy of the owner and beneficiary) using an assumed interest rate.

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<sup>1</sup> For qualified plans and IRAs, see Internal Revenue Code (IRC) § 72(t). For nonqualified annuities, see IRC § 72(q). For SIMPLE IRAs, the penalty is increased to 25% during the first two years of participation. See IRC § 72(t)(6).

<sup>2</sup> See Notice 2022-06; Notice 2004-15; Rev. Rul. 2002-62; Notice 89-25.

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The same life expectancy tables are used as with the RMD method. The interest rate must not exceed the greater of (i) 5% or (ii) 120% of the federal mid-term rate for either of the two months immediately preceding the month in which distributions begin. The payout is calculated at the outset and remains the same throughout the payment period.

### 3. Fixed Annuitization Method

The annual payment is calculated by dividing the account balance by an annuity factor. The annuity factor is the present value of an annuity of \$1 per year beginning at the owner's age and continuing for his life expectancy, or the joint life expectancy of the owner and beneficiary. Life expectancy is determined using an IRS mortality table [Appendix C]. As with the fixed amortization method, the interest rate must not exceed the greater of (i) 5% or (ii) 120% of the federal mid-term rate for either of the two months immediately preceding the month in which distributions begin. The annual payment is determined once and remains the same each succeeding year.

The RMD method provides the lowest payments in the early years. As a result, this method "ties up" a larger amount to produce a given initial payout than other methods. While many might view this as a negative, the RMD method involves a recalculation each year which adjusts the payout based on the size of the end-of-previous-year balance. Using the RMD method could be advantageous in a volatile market, as it reduces the risk of depleting the account.

There is no formal election when taking SOSEPP payments. Taxpayers need to work with their tax adviser to determine which method works best for the individual client's situation and keep records of the account balance and calculation of the SOSEPP.<sup>3</sup>

## Modifications

Although payments under the SOSEPP exception must be designed at inception so they are small enough that the payments would endure for life or life expectancy if permitted to run their course, the payments don't have to continue for that entire time period. The payments may be modified, or even stopped, after *the later of*:

- The taxpayer's age 59½; or
- Five years.<sup>4</sup>

Modifying the payments before the permissible time triggers the 10% penalty retroactively back to when the payments began, sometimes referred to as the penalty being "recaptured."<sup>5</sup> However, not all changes to payments are impermissible modifications, even if they occur before age 59½ or before five years of payments have occurred.

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<sup>3</sup> The IRA custodian or qualified plan administrator will typically issue a 1099-R listing an early distribution with no known exception to the penalty. Taxpayers must file Form 5329 to claim the exception.

<sup>4</sup> IRC §§ 72(t)(4); 72(q)(3).

<sup>5</sup> The recapture penalty and interest are reported on IRS Form 5329.

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## 1. Things that do constitute an impermissible modification

- a. *Partial transfers, additions, rollovers.* A modification will occur if “there is (1) any addition to the account balance other than by reason of investment experience, (2) any transfer of a portion of the account balance to another retirement plan, or (3) a rollover of the amount received...”<sup>6</sup>
- b. *Withdrawal prior to completion of duration requirement.* If the goal is to modify or stop SOSEPP distributions after five years and assuming five years is later than age 59½, a modification needs to wait until the actual date of the fifth anniversary of the first distribution.<sup>7</sup>

## 2. Things that do NOT constitute an impermissible modification

- a. *One-time change to RMD method.* A one-time change to the RMD method from another method is permitted. This one-time change rule was created in 2002 to help mitigate the risk of SOSEPPs depleting taxpayers’ IRAs following a significant drop in the stock market. The rule was reaffirmed in 2022.<sup>8</sup>
- b. *Annual recalculation.* In several private letter rulings, the IRS approved payouts that were designed to be recalculated each year to account for fluctuations in values and interest rates.<sup>9</sup> The annual recalculation must take place from the start rather than being added later, and subsequent calculations must be performed in the same manner as the first.
- c. *Custodian error.* A failure to take a distribution under a SOSEPP does not constitute a modification where the failure was due to a custodian error.<sup>10</sup>
- d. *Change in frequency of payments.* A switch in the schedule of payments (e.g., monthly to quarterly, quarterly to annual) does not constitute a modification if the same amount is withdrawn each year.<sup>11</sup>
- e. *Additional SOSEPP from another IRA.* Initiating another SOSEPP from another IRA does not trigger modification of the first SOSEPP, assuming the individual is not aggregating IRAs for purposes of the SOSEPP calculation.<sup>12</sup>

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<sup>6</sup> Notice 2022-6, Sec. 3.02(e).

<sup>7</sup> See *Arnold v. Commissioner*, 111 TC 250 (1998).

<sup>8</sup> Rev. Rul. 2002-62, Section 2.03(b); Notice 2022-06, Section 3.03(b).

<sup>9</sup> Priv. Ltr. Ruls. 200943044, 200551032, 200432021.

<sup>10</sup> Priv. Ltr. Ruls. 201309020, 201235029.

<sup>11</sup> Priv. Ltr. Ruls. 201051025, 8919052.

<sup>12</sup> Priv. Ltr. Ruls. 200309028, 200033048.

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- f. *Withdrawal that satisfies another exception.* In a somewhat surprising ruling, the Tax Court held that an extra distribution which qualifies for some other exception (e.g., payment of higher education expenses) does not trigger a modification of a SOSEPP.<sup>13</sup>
- g. *Depletion of account.* If a SOSEPP ceases because the IRA has been depleted (e.g., due to poor investment performance), the cessation does not constitute a modification which triggers the penalty.<sup>14</sup>
- h. *Converting to a Roth.* You can convert to a Roth without triggering the penalty.<sup>15</sup>

### Aggregation

While IRA assets are permitted to be aggregated in any combination for purposes of calculating a SOSEPP,<sup>16</sup> they are not required to be aggregated.<sup>17</sup> Consequently, if an IRA is so large that taking SOSEPPs from it would produce payments that are larger than needed, it makes sense to split the IRA into two so that the SOSEPPs come from only one IRA. The other IRA can be tapped into later if additional funds are needed. Even if a withdrawal from the second IRA would trigger a 10% penalty, it would only do so on that withdrawal, and it would not force a recapture of the penalty on the entire SOSEPP from the first IRA.

The IRA owner should therefore determine how much is needed as a payout and engage in some reverse engineering to determine the amount necessary to generate that payout over life or life expectancy. This way, only the IRA assets needed to produce the desired payout are “tied up” during the duration of the SOSEPP.

### Commercial annuities

Legislative history, Revenue Rulings, Notices, and Private Letter Rulings have created a fair amount of uncertainty about whether commercial annuities can satisfy the SOSEPP rules.

#### 1. Annuitizations which probably work

- a. *Fixed annuitizations.* For a fixed annuity, the insurance carrier typically credits interest to the account value at a rate or rates specified in the contract, with a guaranteed minimum. Based on the legislative history to the Tax Reform Act of 1986, a fixed annuity payout for life should satisfy the definition of SOSEPP.<sup>18</sup>
- b. *Variable annuitizations.* In a variable annuity, the contract value is equal to the sum of all accumulation units in the variable account. The value of an accumulation unit might increase or decrease from one valuation to the next because of investment experience, but the number of

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<sup>13</sup> *Gregory T. Benz v. Comm.*, 132 TC No. 15 (2009).

<sup>14</sup> Notice 2022-06, Sec. 3.02(f).

<sup>15</sup> Treas. Reg. § 1.408A-4, Q&A 12.

<sup>16</sup> Priv. Ltr. Rul. 9747039.

<sup>17</sup> Priv. Ltr. Ruls. 200309028, 9050030.

<sup>18</sup> General Explanation of the Tax Reform Act of 1986, Staff of the Joint Committee on Taxation, at 717 (1987).

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accumulation units withdrawn to make each periodic payment does not change. The fact that this variation in values takes place does not make annuity payouts fail the SOSEPP test.<sup>19</sup>

- c. *Period certain annuitizations.* To meet the SOSEPP exception, the annuity payout must not only be substantially equal, but must also be calculated over the owner's lifetime (or joint life of the owner and beneficiary). A period certain payout would meet the SOSEPP exception only if it is designed to last for the individual taxpayer's life expectancy. This is rarely used.

### 2. Annuitizations which probably don't work

- a. *Portfolio or "participating" annuitizations.* In our Northwestern Mutual portfolio deferred income annuities (PDIA) and portfolio immediate income annuities (PIIA), Northwestern Mutual offers a guaranteed income but provides the potential for growth of the payout through dividends. Due to the potential fluctuation in payments when dividends are paid (a form of modification), payouts from our PDIA and PIIA likely do not satisfy SOSEPP requirements.
- b. *Annuitization with a specified annual increase.* Some annuity products, including some offered at Northwestern Mutual, allow the owner to elect a constant annual increase, such as 1%, 2%, or 3% annually. While the IRS has previously interpreted such an increase as satisfying the SOSEPP definition,<sup>20</sup> more recent guidance from the IRS says otherwise.<sup>21</sup>

## Conclusion

The SOSEPP exception provides one possible way for those under age 59½ to access their money without penalty. The ability to adjust payments later in certain circumstances means the payment amount is not locked in forever. However, as with most things in tax law, it can be more complicated than it first appears. Competent legal and accounting advice is strongly recommended.

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<sup>19</sup> Priv. Ltr. Rul. 200818018.

<sup>20</sup> Priv. Ltr. Ruls. 9747045, 9723035.

<sup>21</sup> Priv. Ltr. Rul. 201120011.

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**Appendix A: Single Life Table: Treas. Reg. § 1.401(a)(9)-9(b)**

Taxpayer's Age	Life Expectancy	Taxpayer's Age	Life Expectancy	Taxpayer's Age	Life Expectancy	Taxpayer's Age	Life Expectancy
0	84.6	31	54.4	62	25.4	93	4.6
1	83.7	32	53.4	63	24.5	94	4.3
2	82.8	33	52.5	64	23.7	95	4.0
3	81.8	34	51.5	65	22.9	96	3.7
4	80.8	35	50.5	66	22.0	97	3.4
5	79.8	36	49.6	67	21.2	98	3.2
6	78.8	37	48.6	68	20.4	99	3.0
7	77.9	38	47.7	69	19.6	100	2.8
8	76.9	39	46.7	70	18.8	101	2.6
9	75.9	40	45.7	71	18.0	102	2.5
10	74.9	41	44.8	72	17.2	103	2.3
11	73.9	42	43.8	73	16.4	104	2.2
12	72.9	43	42.9	74	15.6	105	2.1
13	71.9	44	41.9	75	14.8	106	2.1
14	70.9	45	41.0	76	14.1	107	2.1
15	69.9	46	40.0	77	13.3	108	2.0
16	69.0	47	39.0	78	12.6	109	2.0
17	68.0	48	38.1	79	11.9	110	2.0
18	67.0	49	37.1	80	11.2	111	2.0
19	66.0	50	36.2	81	10.5	112	2.0
20	65.0	51	35.3	82	9.9	113	1.9
21	64.1	52	34.3	83	9.3	114	1.9
22	63.1	53	33.4	84	8.7	115	1.8
23	62.1	54	32.5	85	8.1	116	1.8
24	61.1	55	31.6	86	7.6	117	1.6
25	60.2	56	30.6	87	7.1	118	1.4
26	59.2	57	29.8	88	6.6	119	1.1
27	58.2	58	28.9	89	6.1	120+	1.0
28	57.3	59	28.0	90	5.7		
29	56.3	60	27.1	91	5.3		
30	55.3	61	26.2	92	4.9		

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**Appendix B: Uniform Life Table: Notice 2022-06**

Taxpayer's Age	Life Expectancy	Taxpayer's Age	Life Expectancy	Taxpayer's Age	Life Expectancy	Taxpayer's Age	Life Expectancy
10	88.2	38	60.3	66	33.0	94	9.5
11	87.2	39	59.4	67	32.0	95	8.9
12	86.2	40	58.4	68	31.1	96	8.4
13	85.2	41	57.4	69	30.1	97	7.8
14	84.2	42	56.4	70	29.2	98	7.3
15	83.2	43	55.4	71	28.3	99	6.8
16	82.2	44	54.4	72	27.4	100	6.4
17	81.2	45	53.4	73	26.5	101	6.0
18	80.2	46	52.4	74	25.5	102	5.6
19	79.2	47	51.5	75	24.6	103	5.2
20	78.2	48	50.5	76	23.7	104	4.9
21	77.2	49	49.5	77	22.9	105	4.6
22	76.2	50	48.5	78	22.0	106	4.3
23	75.2	51	47.5	79	21.1	107	4.1
24	74.2	52	46.5	80	20.2	108	3.9
25	73.3	53	45.6	81	19.4	109	3.7
26	72.3	54	44.6	82	18.5	110	3.5
27	71.3	55	43.6	83	17.7	111	3.4
28	70.3	56	42.6	84	16.8	112	3.3
29	69.3	57	41.6	85	16.0	113	3.1
30	68.3	58	40.7	86	15.2	114	3.0
31	67.3	59	39.7	87	14.4	115	2.9
32	66.3	60	38.7	88	13.7	116	2.8
33	65.3	61	37.7	89	12.9	117	2.7
34	64.3	62	36.8	90	12.2	118	2.5
35	63.3	63	35.8	91	11.5	119	2.3
36	62.3	64	34.9	92	10.8	120+	2.0
37	61.3	65	33.9	93	10.1		

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**Appendix C: Mortality Table: Treas. Reg. § 1.401(a)(9)-9(e)**

Taxpayer's Age	Probability of Death	Taxpayer's Age	Probability of Death	Taxpayer's Age	Probability of Death	Taxpayer's Age	Probability of Death
0	0.001762	31	0.000799	62	0.006071	93	0.139936
1	0.000441	32	0.000824	63	0.006624	94	0.154844
2	0.000292	33	0.000833	64	0.007225	95	0.171902
3	0.000232	34	0.000830	65	0.007884	96	0.187210
4	0.000177	35	0.000823	66	0.008238	97	0.204659
5	0.000161	36	0.000819	67	0.008659	98	0.222921
6	0.000153	37	0.000824	68	0.009163	99	0.241884
7	0.000145	38	0.000836	69	0.009767	100	0.261476
8	0.000132	39	0.000853	70	0.010491	101	0.281536
9	0.000127	40	0.000879	71	0.011358	102	0.301847
10	0.000128	41	0.000909	72	0.012385	103	0.322371
11	0.000135	42	0.000945	73	0.013598	104	0.342940
12	0.000146	43	0.000980	74	0.015014	105	0.361261
13	0.000164	44	0.001019	75	0.016670	106	0.372886
14	0.000192	45	0.001065	76	0.018587	107	0.381098
15	0.000223	46	0.001132	77	0.020815	108	0.383358
16	0.000253	47	0.001225	78	0.023391	109	0.385709
17	0.000276	48	0.001345	79	0.026387	110	0.388092
18	0.000293	49	0.001485	80	0.029850	111	0.390353
19	0.000304	50	0.001656	81	0.033883	112	0.392822
20	0.000313	51	0.001874	82	0.038544	113	0.395188
21	0.000343	52	0.002121	83	0.043880	114	0.397567
22	0.000377	53	0.002397	84	0.049956	115	0.400000
23	0.000421	54	0.002701	85	0.056799	116	0.400000
24	0.000466	55	0.003032	86	0.064436	117	0.400000
25	0.000520	56	0.003390	87	0.072882	118	0.400000
26	0.000581	57	0.003774	88	0.082137	119	0.400000
27	0.000630	58	0.004181	89	0.092172	120+	0.400000
28	0.000677	59	0.004613	90	0.102919		
29	0.000720	60	0.005071	91	0.114344		
30	0.000763	61	0.005554	92	0.126605		