New Interest Rate Selection Rules For 2022

Actually a little history is appropriate starting with Notice 89-25 (issued some three years after the Tax Reform Act of 1986). We need to look at four time periods:

--- From 1986 to mid 1989 there were no rules; no methods and therefore no interest rate rules.

--- From mid-1989 to late 2002 we have:

"At an interest rate that does not exceed a reasonable interest rate on the date payments commence...an interest rate of 8%, could satisfy §72(t)(2)(A)(iv)[1]"

This was thought to be great news at that time; 8% was blessed and a series of PLRs during the early 1990's further blessed just about any single digit interest rate[2]. But, was 8% reasonable? Using 8% to amortize an IRA results in an annual distribution of approximating 9% to 10% of the beginning principal balance. Therefore, we would suggest:

(1) Using 8% to amortize for a lifetime is very unreasonable[3].

(2) Using 8% to amortize for 5 to 10 years is most likely reasonable.

--- From 2003 to 2022 we have:

"Any interest rate that is not more than 120% of the federal mid-term rate (determined in accordance with §1274(d) for either of the two months immediately preceding the month in which the distribution begins)."

These applicable federal rates are not made up numbers; rather they are a somewhat time lagged measurement of actual market driven interest rates on various US securities; in our case with heavy emphasis on the slope of the interest rate curve between 5 year and 10 year treasuries.

Further, these rates have been abysmally low for the last 15 years. 2022 is likely

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1 This is an excerpt from the amortization methodology paragraph of Notice 89-25.

2 We later learned in Farley v Commissioner (T. C. Summ. Op. 2003-43 WL 192472) that 29% was deemed unreasonable.

3 There have been multiple survivability studies, sometimes called safe withdrawal rate studies, starting with the Ibbotson brothers in the Trinity study conducted in 1998 that suggest that a safe rate is somewhere between 4% and 5%. Above 5% was considered unsafe in that the probability of living and being broke in one's later years rose precipitously.

to get above 2% for 1st time in decades. As a result, maximum withdrawal rates fell from the 9% to 10% range (1989 to 2002) to 2% to 3% in the 2002 to 2022 era[4].

--- Commencing 2023 we get a new set of rules:

"The interest rate that may be used...is any interest rate that is not more than the greater of (I) **5%** or (ii) 120% of the federal mid-term rate (determined in accordance with §1274(d) for either of the two months immediately preceding the month in which the distribution begins)."

Optional for 2022 and mandatory commencing in 2023, the IRS just gave every new SEPP plan the potential for a 60% to 75% upward bump in annual distributions: old rules — approximately $35,000 per $1mm of assets; new rules --- approximately $64,000. Is this an admission by the IRS that the old rules (from 2003 to 2022) were to harsh? Unknown. Does this change invite setting interest rates too high in a taxpayer's plan thus over-distributing to early? Again, unknown. What if 6% to 12% inflation returns and accordingly, the Federal Reserve radically increases short-term rates and we get applicable federal rates greater than 5% resulting in really big distribution percentages? Unknown for the third time[5].

So what do we know? The rules have clearly been relaxed — but, that is not an automatic free pass to jump in the deep end of the pool! Instead, we would suggest that it is more important than ever to clearly define one's financial objectives and time frame. As discussed earlier, we think distributing 6% to 8% of assets for 6 to 12 years is likely fine when the taxpayer is looking at material modification in their revenue sources in the intermediate future. Conversely, we think this is an invitation for disaster when looking at a 30 year or more lifetime.

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4 The author would suggest that both of these interest rate ranges were wrong. High interest rates materially risk failing in the safe withdrawal rate department. Artificially low interest rates drive taxpayers out of this market as a viable income strategy because their IRA balances needed to triple to get the same result. Lastly, we would suggest that the IRS has no authority to fix interest rates to begin with; then again, they didn't call us for our opinion before issuing their pronouncements.

5 Interestingly, 2022 -2023 has seen a spike in inflation resulting in the Federal Reserve increasing the discount rates dramatically. This directly resulted in short and mid-term Treasury rates to rise correspondingly such that by the Fall fo 2023, 120% of the mid-term applicable federal rate rose all the way to 5.79%. Since then, inflation appears to be moderating and the interest rate wizards of Wall Street are predicting that the Federal Reserve will now start reducing rates. Accordingly, as of February, 2024, these rates have dipped below 5%.