Key Issue 34B: The 10% and 25% Early (Premature) Distributions Tax on Qualified Retirement Plans.

General Rules and Exceptions to Penalty Tax

IRC Sec. 72(t) imposes a 10% penalty tax (25% for certain SIMPLE IRAs—see discussion later in this key issue) on the taxable amount of distributions [including a lump-sum distribution (LSD)] from qualified retirement arrangements (including traditional, Roth, SEP, and SIMPLE IRAs) received before age $59^1/_2$ (i.e., early or premature distributions). The penalty does not apply to the following distributions [IRC Sec. 72(t)(2)]:

1. Made upon the death of the employee (does not apply to modified endowment contracts). However, if the distribution is rolled over into a beneficiary's IRA, this exception to the under age $59^1/_2$ penalty no longer applies to any future distributions from the beneficiary's IRA. Instead, the beneficiary's circumstances will determine whether any of the exceptions apply (*Gee*).

2. Attributable to the employee becoming disabled.

Note: Disabled is defined as unable to engage in any substantial gainful activity because of any medically determined physical or mental impairment that can be expected to result in death or be of a long-continued and indefinite duration [IRC Sec. 72(m)(7)]. Substantial gainful activity refers to the activity, or a comparable activity, in which the individual customarily engaged prior to the disability [Reg. 1. 72-17A(f)]. The disability does not need to be permanent. In *Rideaux*, a boiler mechanic was allowed to claim the disability exception when his disability was indefinite because it was impossible to predict when he would be able to resume working.

3. Part of a series of substantially equal periodic payments (an annuity) based on the life of the employee or the joint lives of the employee and a designated beneficiary (see discussion later in this key issue). For distributions from qualified plans other than IRAs, this exception applies only if the employee separates from service.

4. Less than or equal to the employee's Section 213 deductible medical expenses (i.e., medical expenses in excess of 7.5% of AGI—see Chapter 25), determined without regard to whether the employee itemizes deductions. This exception applies only if the medical expenses are actually paid in the same year the distribution is received (*Kimball*).

Observation: There is no requirement that the proceeds from the withdrawal be traced to payment of the qualified Section 213 medical expenses. However, the Tax Court imposed the 10% early withdrawal penalty when a taxpayer had sufficient medical expenses (after the 7.5% AGI limitation) to cover the amount of funds distributed. Since the taxpayer had indicated that the withdrawn funds were not used for payment of medical expenses, the Tax Court did not consider the medical exception (*Milner*).

Planning Tip: To avoid the penalty tax, it is crucial to take the distribution in the year that

qualifying medical expenses are paid. Thus, distributions should not be made near year-end unless the taxpayer is sure that sufficient medical expenses have already been paid, or will be paid by year-end. Otherwise, it makes sense to delay the distribution until the year the expenses are paid.

5. Made on account of a federal tax levy only if the qualified plan or IRA is actually subjected to levy.

6. Made to a reservist or National Guard member during his or her period of duty if the reservist was called to active duty for a period exceeding 179 days after September 11, 2001.

7. Made to an employee after separation from service after reaching age 55 (age 50 if a qualified public safety employee).

8. Paid to an alternate payee (generally in connection with a divorce) pursuant to a qualified domestic relations order (QDRO).

Note: Items 7 and 8 do not apply to distributions from IRAs (including traditional, Roth, SEP, or SIMPLE IRAs), annuities, or modified endowment contracts (i.e., single life insurance policies); they apply only to distributions from qualified retirement plans. Although item 7 does not apply to IRAs, IRC Sec. 408(d)(6) provides the same result for IRA funds transferred to a spouse or former spouse under a divorce or separation agreement.

Note: There is no "financial hardship" exception to the 10% early withdrawal penalty (*Sheikh*; *Gallagher*). Thus, retirement plan distributions used to meet normal living expenses following a job loss or pay cut are subject to income tax and penalty, unless the distribution meets one of the specified exceptions. The only exceptions are those in the preceding list plus the additional exceptions for certain IRA distributions discussed later.

401(k) is qualified retirement plan)

Certain transactions, such as borrowing from an IRA or pledging IRA assets as security for a loan, will trigger a deemed distribution (and thus income recognition) of that portion of the IRA balance borrowed or used to secure the loan [IRC Sec. 408(e)(3) and (4)]. Such deemed distributions can also give rise to the 10% tax on early distributions. Furthermore, investing IRA funds in certain types of collectibles (e.g., art, rugs, antiques, gems, stamps, certain coins—see Key Issue 7A) results in a deemed distribution of the cost of the investment and results in the 10% tax [IRC Sec. 408(m)]. The 10% tax also applies to early distributions (before age 59$^{1}/_{2}$) from modified endowment contracts (more commonly known as single premium life insurance policies) and tax-deferred annuities [IRC Sec. 72(q) and (v)]. (See Key Issue 34C for more on tax-deferred annuities.)

Preparation Pointer: The 10% (or 25%, if applicable) early distributions tax is calculated and reported on Part I of Form 5329. However, Form 5329 is not required if the taxpayer only owes the 10% tax on early distributions and distribution code 1 is shown on Form 1099-R. In such cases, enter 10% of the taxable early distribution on line 59 of Form 1040 and write "No" on the dotted line next to line 59 to indicate Form 5329 is not required. When other exceptions to the penalty apply, Part 1 of Form 5329 should be completed and the appropriate amount and exception code (see the Form 5329 instructions) entered on line 2.

The 2008 Heroes Act (Heroes Act) provides relief from the early distributions tax to qualified reservists who receive distributions while on active duty if called to service after September 11, 2001 [IRC Sec. 72(t)(2)(G)(iv), as amended by the Heroes Act]. A qualified reservist is a member of a "reserve component" as defined in 37 USC Sec. 101, which includes both the military reserves and the National Guard. There is no monetary limit on the distribution.

A qualified reservist distribution is any distribution that is—

1. from an "eligible retirement plan" (see below);

2. made after September 11, 2001;

3. to a qualified reservist who is called to active duty for more than 179 days or for an indefinite period; and

4. made during the period beginning on the first day the reservist received a call to duty and ending on the last day of the active duty period.

An eligible retirement plan is defined under IRC Sec. 72(t)(2)(G)(iv), as amended by the Heroes Act, as:

1. an individual retirement plan (IRA) including a SEP;

2. amounts attributable to employer contributions made pursuant to elective deferrals described in IRC Sec. 402(g)(3)(A) and (C) [401(k) plans or 403(b) annuity contracts]; or

3. amounts attributable to employer contributions made pursuant to elective deferrals described in IRC Sec. 501(c)(18)(D)(iii) (a plan created before June 25, 1959 for the payment of benefits and funded only by employee contributions, where the employee could designate certain contributions as deductible).

Example 34B-1: Qualified reservist distribution.

Gary Isaac Josephs (age 32) has been a member of the Colorado National Guard since October 7, 1998. On May 12, 2008, he received a call to active duty for an indefinite period. On October 29, 2008, he requested and received a distribution of $150,000 from his individual retirement account. He will need to file a return reporting $150,000 in income, but will not be subject to the 10% excise tax.

Observation: This provision is retroactive for distributions after September 11, 2001. If a return was previously filed reflecting the excise tax on a qualified reservist distribution, the taxpayer should consider filing an amended return to request a refund. "Active duty reservist" should be written on the top of the form. In Form 1040X, Part II, Explanation of Changes, the reservist should include the date he/she was called to active duty, the amount of the retirement distribution, and the amount of early-distribution tax paid (IR-2006-152).

Example 34B-2: Qualified reservist distribution in earlier year.

Assume the same facts as Example 34B-1, except the call to duty and distribution occurred in 2005. On March 18, 2006, Gary filed his 2005 return reflecting $150,000 in taxable income and $15,000 in excise tax. Gary should file an amended 2005 return on or before April 15, 2009 and request a refund of the $15,000 excise tax.

The distribution is taxable in the year received. The amount of income included is computed in the same manner as any other retirement distribution (see Key Issues 5B, 5C, and 5E).

The qualified reservist may repay the distribution with one or more contributions within two years of ending his/her term of active duty or August 17, 2008, whichever is later [IRC Sec. 72(t)(2)(G)(iv), as added by the Pension Protection Act of 2006 (2006 Pension Act)]. The normal contribution limits will not apply to the repayment, and the full amount of the original distribution may be replaced in the plan. However, no deduction is allowed for such a contribution [IRC Sec. 72(t)(2)(G)(ii), as added by 2006 Pension Act].

Example 34B-3: Qualified reservist repayment of distribution within two years.

Assume the same facts as Example 34B-1. Gary completes his tour of duty on February 2, 2009. He realizes he did not need the entire $150,000 and wishes to replace $100,000 in his individual retirement account. As long as he repays the $100,000 to the account no later than February 1, 2011, he will not be subject to the contribution limitations. Since he will not receive a deduction for the contribution, his basis in his IRA would increase by $100,000.

Qualified public safety employees may receive distributions from a government plan [as defined in IRC Sec. 414(d)] after separation from service at age 50, rather than waiting until attaining age 55. Qualified public safety employees include police, firefighters, and emergency medical technicians [IRC Sec. 72(t)(10)(B), as added by 2006 Pension Act].

Additional Exceptions for Certain IRA Distributions. In addition to items 1–5 in the preceding list of exceptions, additional exceptions to the 10% penalty exist only for IRA withdrawals (traditional, Roth, SEP, and SIMPLE IRAs). These are:

1. *Medical Insurance Premiums.* Withdrawals up to the amount paid for deductible medical and long-term care insurance (without regard to the 7.5% AGI floor) if the individual (including a self-employed individual) has received unemployment compensation under federal or state law for at least 12 consecutive weeks in the year of the withdrawal or the previous year [IRC Sec. 72(t)(2)(D)]. Because self-employed individuals are not eligible for unemployment compensation, the law treats them as having received unemployment compensation for at least 12 weeks if they would have qualified for unemployment had they not been self-employed. The medical insurance provision does not apply to withdrawals made after the individual has been reemployed for 60 days.

2. *Higher Education Expenses.* Withdrawals to the extent they do not exceed the qualified higher education expenses of the taxpayer, spouse, or any child, stepchild, or grandchild [IRC Sec. 72(t)(2)(E)]. The qualified higher education expenses must occur in the same taxable year as the withdrawals (*Lodder-Beckert*). Qualified higher education expenses are defined the same as for qualified tuition programs. (See Key Issue 6J.) Room and board are included only if the student attends at least half time. Computers qualify as eligible equipment only if required as a condition of enrolling in the qualified institution (*Gorski*). The amount of qualified higher education expenses must be reduced for certain scholarships.

3. *First-time Home Purchase.* Up to $10,000 of cumulative (lifetime) withdrawals used for homebuying costs for a first-time homebuyer who is either the taxpayer or the taxpayer's spouse, child, grandchild, or ancestor or spouse's ancestor [IRC Sec. 72(t)(2)(F)]. The $10,000 lifetime limit is per individual. Distributions must be used within 120 days after receipt for costs to acquire, construct, or reconstruct a principal residence for an eligible taxpayer who has not (nor has his or her spouse, if married) had any present ownership interest in a principal residence during the two-year period ending on the date of acquisition. If acquisition is delayed or canceled, the withdrawal can be rolled back tax-free into an IRA under the IRA rollover rules, except the rollover period is 120 days rather than the normal 60 days from the date of withdrawal [IRC Sec. 72(t)(8)(E)].

Example 34B-4: Penalty-free IRA withdrawal for first-time homebuyer.

Loni wants to move out of her apartment and into a house. Her father, John, age 50, agrees to help her buy this first home. On March 31, 2008, John withdraws $9,000 from his traditional IRA. The withdrawal is included in John's 2008 gross income for income tax purposes, but is not subject to the 10% early withdrawal penalty tax if Loni uses the funds no later than July 29, 2008 (i.e., 120 days from March 31, 2008) to buy a specific house (or start construction of a new house). The $9,000 must go toward the purchase price or other costs of acquiring the house.

If Loni's purchase of a house is delayed or cancelled so that the 120-day deadline will not

be met. John can redeposit the $9,000 into his IRA without penalty. If he does not redeposit the funds and the 120-day period expires, the $9,000 is included in John's 2008 gross income and is subject to the early withdrawal penalty (in 2008) because he is under age 59 1/2.

Penalty-free IRA withdrawals for first-time homebuyers are limited to $10,000 during the taxpayer's lifetime, so John has $1,000 more that he can withdraw for qualified homebuying purposes. If John is married, his wife would still be eligible to take up to $10,000 from her IRAs penalty-free if used for "first-time" home buying expenses.

Practice Tip: It is important to note that two of the penalty exceptions (for medical expenses and education expenses) are for withdrawals up to the amount of the eligible expenditure. Thus, there is no tracing rule that requires the funds withdrawn from the account be the funds actually used for the expenditure; instead, it is permissible to pay the expenses and withdraw the IRA funds at different times during the tax year. However, the actual payment of the expenses and the withdrawal must occur within the same tax year. Also, the exceptions allowed only for IRA distributions include IRAs funded with rollovers from employer plans.

Nonqualified Distributions Following Roth IRA Conversions

The taxable portion (if any) of Roth IRA distributions are subject to the same rules for the 10% premature distribution penalty as traditional IRAs. However, distributions from Roth IRAs resulting from a conversion of a traditional IRA (see Key Issue 5D) are subject to an additional rule. Any portion of a Roth IRA distribution allocable to a converted traditional IRA is subject to the 10% penalty tax if made within the five-tax year period beginning with the year of the conversion [IRC Sec. 408A(d)(2)(B); Reg. 1.408A-6, Q/A-5]. However, if the distribution allocable to the traditional IRA is made because of the death of the taxpayer, IRC Sec. 72(t) provides an exception to the penalty. The penalty applies as if such portion were included in income, but does not apply if a Section 72(t) exception applies (e.g., the taxpayer was over age 59 1/2 when the distribution was received).

25% Penalty Applicable to SIMPLE IRAs

The 10% penalty discussed previously is increased to 25% for certain premature SIMPLE IRA distributions. If, during a two-year period (beginning the day the employee first participates in any SIMPLE IRA plan maintained by the employer) a participant who is not yet age 59 1/2 receives a distribution (to which none of the above 10% penalty exceptions apply), the early distribution tax is 25% rather than 10% [IRC Sec. 72(t)(6)]. For this rule, an employee begins participating in a SIMPLE IRA plan on the day the employer first deposits contributions to the employee's SIMPLE IRA (IRS Notice 97-6, I-5). (See Key Issues 5I and 7D for more on SIMPLE IRAs.)

Example 34B-5: Penalty on SIMPLE IRA plan distribution.

Jennifer, age 28, enters her employer's SIMPLE IRA plan on January 1, 2008. Her employer makes the first deposit into her SIMPLE IRA on January 15, 2008. Jennifer quits on October 15, 2008, when she has $4,000 in her SIMPLE IRA. If she withdraws the $4,000, what are the tax consequences of the distribution (assuming she does not roll over the proceeds into another SIMPLE IRA within 60 days—see Key Issue 5F for a discussion of rollovers)? [Since she has not participated in the SIMPLE IRA plan for two years, she cannot roll the proceeds over to a traditional or Roth IRA (and cannot roll it into a qualified plan in any event).] The $4,000 distribution will be subject to the 25% early distribution tax as well as income tax. It will be reported to Jennifer on a Form 1099-R, with distribution code "S" since it is a premature distribution from a SIMPLE IRA. See Illustration 34-2 for Jennifer's 2008 Form 5329 reporting the 25% early distribution tax.
Note: If Jennifer were 60 years old instead of 28, the 25% penalty would not apply

because she would be over age $59^1/2$. The distribution would be fully taxable, however.

Substantially Equal Periodic Payment Exception

The substantially equal periodic payment exception is a useful exception to the premature distribution tax, particularly for distributions from an IRA or SIMPLE IRA before the taxpayer reaches the age of age $59^1/2$. For distributions from qualified plans other than IRAs, this exception applies only if the employee separates from service. To qualify for this exception, the distribution must be a part of a series of substantially equal periodic payments made at least annually for the life (or life expectancy) of the account owner or the joint lives (or joint life expectancies) of the individual and his designated beneficiary [IRC Sec. 72(t)(2)(A)(iv)]. Payments under this exception need not continue for the life of the individual, but they must continue until the later of the (1) date the individual turns age $59^1/2$, or (2) close of the five-year period beginning with the date the initial payment was received [IRC Sec. 72 (t)(4)(A)(ii)].

If payments are altered before this time, the 10% premature distribution penalty is applied retroactively (recaptured) in the first year the modification is made (i.e., the penalty is the amount that would have been imposed on the current and all previous distributions had this exception not applied). The penalty is applied only to payments received before the taxpayer turned age $59^1/2$, even if the recapture event occurs after this time (e.g., payments were changed before the end of the five-year period, but after the taxpayer turned age $59^1/2$). In addition, the taxpayer must pay interest on the penalty tax beginning with the tax year the penalty would have been payable and ending on the actual payment date [IRC Sec. 72(t)(4)(A)(ii)(II)].

Caution: The restriction on modifying the payments is strictly applied, and the reason for a modification is irrelevant. For example, in Ltr. Rul. 9818055, the IRS ruled that a 55-year-old taxpayer who had begun a series of substantially equal periodic payments after quitting her job, but discontinued the payments less than one year later after returning to work because of unforeseen circumstances, was subject to the 10% penalty on payments previously received. In *Arnold*, the Tax Court held that a taxpayer who began periodic payments at age 55, but who in the fifth year withdrew an amount in addition to the required payment (because he did not receive other income he had expected that year), modified the payments causing the 10% penalty to apply to all payments received before age $59^1/2$. As noted in Rev. Rul. 2002-62, a modification occurs if, after the date the payments commence, there is (1) any addition to the account balance other than gains or losses, (2) any nontaxable transfer of a portion of the account balance to another retirement account, or (3) a rollover by the taxpayer of the amount received resulting in such amount not being taxable. But if the addition to the account balance was caused by administrative error and not to deliberate action by the taxpayer, modification has not occurred (Ltr. Rul. 200616046).

There are generally three safe harbor methods for computing substantially equal periodic payments: the minimum distribution method, the fixed amortization method, and the fixed annuity factor method. See section 1105 in *PPC's Guide to Tax Planning for High Income Individuals* or section 606 in *PPC's Guide to Individual Retirement Accounts* for details on how to compute the payments under each method. A taxpayer is not required to aggregate his retirement accounts when computing substantially equal periodic payments. Instead, each account is viewed separately so a taxpayer who divides his IRA into multiple IRAs need not consider all IRAs when computing and withdrawing substantially equal periodic payments, provided the requirements are met for the one or more from which periodic payments are withdrawn (Ltr. Rul. 200309028).

Example 34B-6: Substantially equal periodic payments.

Pat Markwood (age 51) owns four individual retirement accounts with balances of \$250,000, \$85,000, \$400,000, and \$175,000, respectively. He wishes to begin receiving substantially equal periodic payments. He may choose to receive payments from all four accounts, from only one account, or from any combination of the four accounts. He is not

required to compute payments for all four accounts.

Observation: If the taxpayer has only one current account but does not wish to receive substantially equal periodic payments based on the entire account balance, he may roll over a portion of the funds into a new individual retirement account. See Key Issue 5F for more information on completing a tax-free rollover.

Example 34B-7: Substantially equal periodic payments—new account.

Jim Young (age 53) owns an individual retirement account with a balance of $850,000 (Account A). He wishes to withdraw substantially equal periodic payments, thereby avoiding the 10% excise tax on early withdrawals, but does not want to compute the payment based on $850,000. Instead, he wishes to compute the amount using $300,000. What can Jim do?

Jim should create a second individual retirement account (Account B) and roll over $300,000 from Account A to Account B. He should use a direct trustee-to-trustee rollover to avoid any withholdings (see Key Issue 5F). Once the new account is set up, Jim can compute the substantially equal periodic payment based on the $300,000 in Account B. The $550,000 remaining in Account A will not affect this calculation. As long as Jim makes no other changes to Account B and receives the payments until he is 59 1/2, he will avoid the 10% excise tax.

10% Penalty and Withdrawals of Excess Contributions

As discussed in Key Issue 34A, excess contributions to IRAs result in a 6% excise tax until corrective action is taken. If the excess contribution is withdrawn before the due date, including extensions, of the return for the year of the contribution, the 6% tax is avoided. Here, the earnings must be withdrawn and must be included in income for the year of the excess contribution. An excess contribution withdrawn after the return due date need not be accompanied by the related earnings. When earnings on an excess contribution are withdrawn and included in income, the 10% premature distribution penalty applies to those earnings if the taxpayer is under age 59 1/2 (IRS Pub. 590).

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