Retirement Plans, IRAs, and Annuities: Avoiding the Early Distribution Penalty

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The tax law imposes a 10% penalty on early distributions from retirement plans, individual retirement arrangements (IRAs), and annuities. Congress designed the penalty as a disincentive for early retirement and pre-retirement withdrawals. There are, however, numerous exceptions to the penalty, some age related and some not.

The penalty applies to distributions from qualified plans, tax-sheltered annuities (TSAs), eligible state or local government plans, IRAs, Roth IRAs, designated Roth accounts, nonqualified plans funded by trusts or annuities, and personally purchased annuities.[1] The penalty does not apply to distributions from eligible tax-exempt organization plans or nonqualified plans not funded by a trust or annuity.[2] Note that the term "taxpayer" as used in this article means any participant in an employer retirement plan (other than a beneficiary) or the owner of an IRA, Roth IRA, or annuity.

The early distribution penalty applies only to amounts that are includible in gross income. Thus, for example, it does not apply to the nontaxable portion of any distribution, nor does it apply to the portion of a distribution rolled over tax free from one plan or IRA to another plan or IRA or from one Roth IRA to another Roth IRA.[3] Furthermore, the penalty does not apply to qualified rollover contributions from a plan or arrangement to a Roth IRA or designated Roth account, even if the rollover is taxable.[4]

Congress has provided many other exceptions to the penalty, exceptions that may vary somewhat with the type of plan or entity making a distribution. This article first addresses those exceptions that are common to all plans and annuities and then discusses exceptions peculiar to specific types of plans or annuities. (Note that the IRS has not issued any final or proposed regulations dealing with the penalty and its exceptions, and the IRS abandoned a previous regulation project.[5])

Common Exceptions

The Age and Death Exceptions

Under the most significant generally applicable exception, the 10% penalty

1 Secs. 72(t)(1) and 4974(c).

2 Secs. 457 and 409A. These plans are not included in Sec. 4974(c).

3 Secs. 72(q)(1) and (t)(1); Regs. Sec. 1.402(c)-2, Q&A-11.

4 Secs. 402A(c)(4)(A)(ii) and 408A(d)(3)(A)(ii).

5 Notice 92-12, 1992-1 C.B. 500.

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tax will not apply to any distributions on or after the date the taxpayer reaches age 59½. It does not matter whether the taxpayer is then retired.[6] The penalty tax also does not apply to distributions to beneficiaries or to a taxpayer's estate after the death of the taxpayer.[7]

The Disability Exception

The penalty does not apply to distributions to a taxpayer after he or she is disabled.[8] However, the disability of a spouse will not qualify a taxpayer for the exception, even in a community property state.[9] A taxpayer is disabled if he or she cannot do substantial work because of a physical or mental medical condition that will last for a long and indefinite period or from which the taxpayer will probably die.[10]

For this purpose, a taxpayer can do substantial work if the taxpayer is capable of working at his or her pre-disability or pre-retirement occupation, or a comparable occupation, with appropriate remediable treatment. Determination of the taxpayer's capability must take into account the taxpayer's education, training, and work experience but most importantly the nature and severity of the impairment. Thus, the regulations provide that a taxpayer "ordinarily" cannot perform substantial work if the taxpayer suffers from one of the following specific impairments:

1. Loss of use of two limbs or physical loss or atrophy of a limb due to certain progressive diseases.
2. Heart, lung, or blood disease causing breathlessness, pain, or fatigue on slight exertion.
3. Inoperable and progressive cancer or other terminal illness.
4. Severe loss of judgment, intellect, orientation, or memory due to brain damage or abnormality.
5. Mental disease requiring continued institutionalization or constant supervision.
6. Severe loss or diminution of vision, permanent and total loss of speech, or total uncorrectable deafness.[11]

The courts tend to apply these regulatory standards narrowly. For example, the Tax Court has held that a taxpayer suffering from clinical depression did not qualify for the disability exception because he continued to trade stocks for himself and others. The court said the taxpayer was engaged in gainful activity because he intended to make a profit from his trading, even though his efforts yielded an overall loss. (The court did not consider the possibility that the taxpayer's condition may have diminished his ability to make a profit.) The court also found that the taxpayer's periodic consultation with psychiatrists did not rise to the level of institutionalization or constant supervision (item 5 above).[12]

In another case, the Tax Court held that a taxpayer did not qualify for the disability exception because he did not show that his clinical depression was irremediable. The court stated that an impairment is remediable if reasonable treatment would allow gainful activity. In this case, the taxpayer actually continued to engage in gainful activity.[13] By contrast, a taxpayer did qualify for the disability exception after contracting AIDS and then suffering a nervous breakdown,[14] as did a taxpayer suffering from multiple sclerosis.[15]

Unfortunately, the courts frequently find that taxpayers have offered inadequate evidence of disability. For example, the receipt of private disability insurance payments and the taxpayer's uncorroborated testimony were insufficient to support the disability exception.[16] The Tax Court also denied the exception to a Christian Scientist whose religious beliefs prevented him from obtaining and offering a medical diagnosis of his condition.[17] Similarly, the court held that evidence of disability was insufficient even though the taxpayer (1) had lost custody of a child

6 Secs. 72(q)(2)(A) and (t)(2)(A)(i); IRS Letter Ruling 200420030 (5/14/04).
7 Secs. 72(q)(2)(B) and (t)(2)(A)(ii).
8 Secs. 72(q)(2)(C) and (t)(2)(A)(iii).
9 *Barkley*, T.C. Memo. 2004-287.
10 Sec. 72(m)(7).
11 Regs. Sec. 1.72-17A(f).
12 *Dwyer*, 106 T.C. 337 (1996).
13 *Kovacevic*, T.C. Memo. 1992-609. See also *Dollander*, T.C. Memo. 2009-187.
14 *Meyer*, T.C. Memo. 2003-12.
15 IRS Letter Ruling 201011036 (3/19/10).
16 *Kowsh*, T.C. Memo. 2008-204.
17 *Fohrmeister*, T.C. Memo. 1997-159.

EXECUTIVE SUMMARY

- In general, a penalty applies to early distributions from retirement plans, individual retirement arrangements (IRAs), and annuities. However, there are many exceptions to this penalty. The application of the penalty and the exceptions to it vary among the different types of plans, accounts, and annuities.
- The penalty exclusions that most commonly apply are the age-related exception and the exception for distributions to beneficiaries after the death of a plan or account owner. However, there are numerous other exceptions based on a taxpayer's specific situation—for example, a disability exception and an exception for distributions used to pay for certain medical care.
- An exception to the penalty is allowed where a taxpayer receives a series of substantially equal periodic payments. A taxpayer has a great deal of flexibility in setting up a qualifying series of periodic payments, but once started the taxpayer generally must continue receiving the payments without modifying their amount or the payments will be subject to the penalty.

he was unable to nurture and (2) actually qualified for Social Security disability in a subsequent tax year.[18]

The Substantially Equal Payment Exception

The 10% penalty tax will generally not apply to a series of substantially equal periodic payments received annually or more frequently.[19] The periodic payments must start after retirement for qualified plans, TSAs, and eligible state or local plans. However, they may start either before or after retirement for IRAs, Roth IRAs, some funded nonqualified plans, and personally purchased annuities.[20]

A taxpayer or beneficiary must receive the substantially equal payments over the taxpayer's lifetime, the joint lifetimes of the taxpayer and beneficiary, a period equal to the taxpayer's life expectancy, or a period equal to the joint and survivor life expectancy of the taxpayer and beneficiary.[21]

Of course, annuity payments of equal amount over the specified periods will generally qualify as substantially equal.[22] For nonannuity payments, a taxpayer may choose any one of the following three methods to compute the amount of the payments:[23]

1. *Fixed amortization method:* Under this method, the taxpayer determines the annual payment by amortizing the initial account balance in equal amounts over the taxpayer's life expectancy (or the joint life expectancies of the taxpayer and beneficiary).
2. *Fixed annuitization method:* The taxpayer determines equal annual payments by dividing the initial account balance by an annuity factor. The annuity factor is the present value of an annuity of $1 per year for the life expectancy of the taxpayer (or the joint life expectancies of the taxpayer and beneficiary).
3. *Required minimum distribution method:* The taxpayer redetermines the annual payment for each distribution year by dividing that year's account balance by the taxpayer's life expectancy for the distribution year (or the joint life expectancies of the taxpayer and beneficiary). A taxpayer may permanently switch to this method from methods 1 and 2 for any year after commencement of payments.[24]

Some deviations from the safe-harbor methods may be possible. For example, the IRS has allowed taxpayers who adopt methods 1 and 2 above to alter those methods by recalculating distributions each year using current account balances, life expectancies, and interest rates.[25] However, a taxpayer generally may not change to or from any such altered method after initial adoption of a method.[26]

Furthermore, the IRS is unyielding in requiring taxpayers to adopt methods using life expectancies derived from the minimum distribution regulations and interest rates no greater than 120% of the federal mid-term rate.[27] Significantly, the Tax Court, in holding that a taxpayer's payments were not substantially equal lifetime payments, noted that the payments were greatly in excess of IRS safe-harbor amounts.[28]

A taxpayer may take a lump-sum distribution from a plan or an IRA (or transfer the amount tax free to another plan or IRA) before commencing substantially equal payments from the remaining account balance. In the case of a qualified plan, TSA, or eligible state or local plan, the distribution or transfer need only be *in connection with* the commencement of substantially equal payments.[29] Nevertheless, if not rolled over, the lump-sum payment itself will generally be a taxable distribution and will be subject to the penalty unless an exception applies.

A taxpayer with several IRAs may compute substantially equal payments for two or more of them in the aggregate and may make the aggregate payments from any one or more of the covered IRAs.[30] A taxpayer may adopt at various times separate streams of substantially equal payments from different IRAs, using different safe-harbor methods of computation.[31]

The IRS may also provide relief for payment methods that it ultimately determines do not qualify as substantially equal lifetime payments. In one private letter ruling,[32] the IRS allowed a taxpayer to restore without penalty certain excess distributions resulting from a series of payments that the IRS ultimately ruled did not qualify. The IRS apparently believed that the taxpayer acted in good faith and thus treated the restoration as a rollover of the excess distributions, even waiving the 60-day requirement normally applicable to rollovers.

In any event, the penalty tax will retroactively apply to substantially equal payments (with interest) if the arrangement is modified before the later of (1) the date the taxpayer reaches age 59½ or (2) the date that is five years after the first payment.[33] Any distribution prior to either of those dates that is not a substantially equal payment will trigger the retroactive penalty, unless the additional distribution itself qualifies for certain other specific penalty exceptions discussed below.[34]

Modifications upon death or disability do not trigger the retroactive penalty.[35] In addition, the IRS has ruled that an incorrect payment or failure to make a payment does not constitute a forbidden

18 *Kane*, T.C. Memo. 1992-218.
19 Secs. 72(q)(2)(D) and (t)(2)(A)(iv).
20 Secs. 72(t)(3)(B) and (t)(9).
21 Secs. 72(q)(2)(D) and (t)(2)(A)(iv).
22 Cf. Regs. Secs. 1.402(c)-2, Q&A-5, and 1.409A-2(b)(2)(ii) (for a discussion of substantially equal payments in similar contexts).
23 Rev. Rul. 2002-62, 2002-2 C.B. 710; Notice 89-25, 1989-1 C.B. 662.
24 Id.
25 IRS Letter Rulings 200616045 (4/21/06), 200601044 (1/6/06), and 200551033 (12/23/05).
26 IRS Letter Ruling 200716032 (4/20/07).
27 Rev. Rul. 2002-62; IRS Letter Ruling 200437038 (9/10/04).
28 *Prough*, T.C. Memo. 2010-20.
29 Notice 89-25; IRS Letter Rulings 200550039 (12/16/05) and 200214029 (4/5/02).
30 IRS Letter Ruling 200131035 (8/6/01).
31 IRS Letter Rulings 200309028 (2/28/03) and 200119060 (5/14/01).
32 IRS Letter Ruling 200442033 (10/15/04).
33 Secs. 72(q)(3) and (t)(4)(A).
34 *Arnold*, 111 T.C. 250 (1998); *Benz*, 132 T.C. 330 (2009).
35 Secs. 72(q)(3) and (t)(4)(A); IRS Letter Ruling 200126037 (7/2/01).

modification when the failure is due entirely to trustee error.[36]

Contributions or rollovers into a plan or IRA after it starts substantially equal payments will constitute a modification that triggers the penalty tax. Similarly, a transfer or rollover to another plan or IRA of part of the account balance used to compute the substantially equal payments will constitute a forbidden modification, even if the taxpayer subsequently rolls the amount back into the original plan or IRA.[37]

The early distribution penalty applies only to amounts that are includible in gross income.

However, the IRS apparently allows a trustee-to-trustee transfer of the entire account balance of an IRA to another IRA if the recipient IRA continues to make the substantially equal payments.[38] The IRS also allows a qualified rollover contribution of the account balance of an IRA to a Roth IRA if the Roth IRA continues to make the payments.[39] It is unclear, however, whether there is a forbidden modification if the recipient IRA or Roth IRA holds unrelated funds.

It is also unclear under what circumstances a forbidden modification occurs when a taxpayer transfers the account balance of a qualified plan, TSA, or eligible state or local plan making substantially equal payments. However, the IRS has ruled that a taxpayer did not modify a payment arrangement when his IRA continued substantially equal payments after receiving a rollover from a *terminating* qualified plan.[40]

The IRS has ruled that transfer of a portion of the account balance of a plan or IRA to a spouse in a divorce proceeding is not a modification of substantially equal payments that will trigger the retroactive penalty. However, the transferring taxpayer must reduce his or her payments to take into account the reduced account balance.[41]

Additional Exceptions for Qualified Plans

Certain other exceptions to the early distribution penalty apply to distributions from qualified plans and TSAs (in addition to the generally applicable exceptions discussed above).

The Retirement Age Exception

The 10% penalty tax generally does not apply to post-retirement distributions received by a taxpayer from a qualified plan or TSA. To qualify for this exception, the taxpayer must generally be at least age 55 during the calendar year of retirement.[42] However, the triggering age is 50 for distributions from a defined benefit plan to qualified public safety employees of states or their subdivisions.[43] Qualified public safety employees include police officers, firefighters, and medical emergency workers.[44]

The QDRO Payments Exception

The penalty tax does not apply to payments to a spouse, former spouse, child, or other dependent under a qualified domestic relations order (QDRO). A QDRO is a court order normally issued in connection with divorce or legal separation. It establishes or recognizes the right of a spouse, former spouse, child, or other dependent to receive specified payments from a qualified plan or TSA.[45]

A QDRO must satisfy certain standards and requirements that vary depending on the type of employer and the type of retirement plan. For example, less stringent qualification requirements apply to qualified governmental plans and qualified church plans. In any event, though, a QDRO payment will qualify for the exception to the penalty only if the QDRO rigidly complies with the relevant substantive requirements and substantially complies with the procedural requirements.[46]

Domestic relations orders not qualifying as QDROs are generally not enforceable. However, despite this general rule, nonqualifying orders are enforceable with respect to qualified government plans, qualified church plans, and certain TSAs (those with minimal employer involvement).[47] Unfortunately, though, the early distribution penalty may still apply to payments under such nonqualifying orders if none of the other penalty exceptions applies.

Exception for Cost of Life Insurance

The proceeds from a life insurance contract owned by a qualified retirement plan or TSA may be payable to a participant's beneficiary, either directly or indirectly. If so, the participant may have to include a portion of the cost of the insurance in his or her gross income. More specifically, the participant must include the portion of the insurance cost paid from funds contributed by the employer or paid from funds earned by the plan.[48]

Fortunately, inclusion in a participant's gross income of life insurance costs paid by a qualified plan will not trigger the penalty tax on early distri-

36 IRS Letter Rulings 200835033 (8/29/08), 200930053 (7/24/09), and 200631025 (8/4/06).

37 Rev. Rul. 2002-62; IRS Letter Rulings 200925044 (6/19/09) and 200720023 (5/18/07).

38 IRS Letter Ruling 200616046 (4/21/06).

39 Regs. Sec. 1.408A-4, Q&A-12.

40 IRS Letter Ruling 9221052 (2/26/92).

41 IRS Letter Rulings 200717026 (4/27/07) and 200214034 (4/5/02).

42 Sec. 72(t)(2)(A)(v); Notice 87-13, 1987-1 C.B. 432, Q&A-20.

43 Sec. 72(t)(10)(A).

44 Sec. 72(t)(10)(B).

45 Secs. 72(t)(2)(C) and 414(p).

46 Sec. 414(p); *Bougas*, T.C. Memo. 2003-194.

47 Secs. 401(a) (last sentence), 401(a)(13), 411(e)(1), 414(d), 414(e), and 414(p)(9); 29 U.S.C. §§1003(b)(1)–(2); 29 C.F.R. §2510.3-2(f).

48 Secs. 72(m)(3)(B) and 404(a)(8)(C); Regs. Secs. 1.72-16(b)(2) and 1.403(b)-8(c)(2); Prop. Regs. Sec. 1.403(b)-6(g); Rev. Rul. 79-202, 1979-2 C.B. 31.

butions. It is also unlikely that the IRS would apply the penalty tax to TSA costs since the IRS determines the includible life insurance costs for TSAs by analogy to qualified plans.[49]

Distributions Not Exceeding Itemized Medical Deductions

The penalty does not apply to distribution amounts that are less than or equal to a taxpayer's allowable itemized medical deductions (whether the taxpayer actually itemizes deductions), if the distributions are used to pay for medical care during the tax year. Because of constraints on itemized medical deductions, this exception is limited to the amount of medical expenses exceeding 7.5% of adjusted gross income.[50] In addition, this exception does not apply to distribution amounts covered by any of the other statutory exceptions.[51]

The taxpayer uses the qualifying medical deductions against (and thus eliminates the penalty on) only the gross income portion of a distribution. That is, the tax law does not require the taxpayer to deplete the medical exception by using it against the portion of a distribution representing tax-free recovery of investment.[52] Note also that the medical deduction exception does not include medical insurance premiums deductible by self-employed individuals as business expenses.[53]

The exception for itemized medical deductions applies even if the taxpayer is also receiving substantially equal periodic payments. That is, the additional distribution for medical expense deductions does not constitute a forbidden modification of the substantially equal payments.[54]

Distributions to Military Reservists

The penalty does not apply to a distribution of elective deferrals from a Sec. 401(k) plan or TSA to a qualifying military reservist. At the time of the distribution, the military reservist must be on active duty for a period of 179 days or for an indefinite period. Within a two-year period after completion of active duty, the reservist may make voluntary nondeductible contributions to an IRA or Roth IRA in an aggregate amount not exceeding the active-duty distributions. Note that the distribution restrictions generally applicable to qualified plans and TSAs do not apply to qualified reservist distributions.[55]

Other Specific Exceptions

Other qualified plan and TSA distributions not subject to the 10% penalty tax include:

1. Payments to the federal government due to lien, levy, garnishment, or seizure.[56] However, the mere threat of such government action is not enough to avoid the penalty.[57]
2. Payments of dividends on employer stock held by an employee stock ownership plan (unless the plan previously invested the dividends in employer stock).[58]
3. Certain distributions to victims of the 2005 hurricanes Katrina, Rita, and Wilma[59] and victims of the 2008 midwestern area storms, tornados, and flooding.[60]

Plan Loans to Taxpayers or Beneficiaries

Loans to a taxpayer or beneficiary from a qualified plan or TSA are generally taxable as distributions unless they satisfy the statutory requirements for qualified residential loans or qualified five-year term loans. Thus, nonqualified loans are subject to the penalty tax if none of the other statutory exceptions applies.[61] Similarly, the portion of a plan interest that the taxpayer or beneficiary assigns or pledges as security for a nonqualified loan is generally subject to the penalty,[62] as are nonqualified loans, assignments, or pledges under annuities purchased by the plan.[63]

5% Owners

Certain 5% owners must pay a separate and additional 10% penalty tax on the portion of distributions in excess of amounts allowable under the plan's terms.[64] A 5% owner, for these purposes, is anyone who during the five plan years preceding the year the amount was received was a 5% owner under the Sec. 416 rules for top-heavy plans.[65]

Additional Exceptions for Eligible State or Local Government Plans

The 10% penalty on early distributions has limited applicability to an eligible state or local government plan. The penalty applies only to distributions from funds previously rolled over to the eligible state/local government plan from a qualified plan, TSA, or IRA,[66] and then only if an exception does not apply.[67] In addition to the generally applicable exceptions discussed initially in this article, the following exceptions specifically apply to such distributions.

The Retirement Age Exception

The penalty tax will not apply to plan distributions after retirement if the

49 Notice 89-25, Q&A-11; Prop. Regs. Sec. 1.403(b)-6(g).

50 Secs. 72(t)(2)(B) and 213(a). The threshold permanently increases to 10% after 2012 but remains at 7.5% for taxpayers aged 65 and older for tax years through 2016 (Patient Protection and Affordable Care Act of 2010, P.L. 111-148, §9013).

51 Sec. 72(t)(2)(B); *Benz*, 132 T.C. 330 (2009).

52 *Argyle*, T.C. Memo. 2009-218.

53 Sec. 162(l); *Mitchell*, T.C. Memo. 2006-101.

54 *Benz*, 132 T.C. 330 (2009).

55 Sec. 72(t)(2)(G); Notice 2010-15, 2010-6 I.R.B. 390.

56 Sec. 72(t)(2)(A)(vii); *Hosking*, 567 F.3d 329 (7th Cir. 2009); *Murillo*, T.C. Memo. 1998-13, *acq.*, 1999-1 C.B. 332; IRS Letter Ruling 200426027 (6/25/04).

57 *Willhite*, T.C. Memo. 2009-263.

58 Sec. 72(t)(2)(A)(vi); Notice 2002-2, 2002-1 C.B. 285, Q&A-7.

59 Sec. 1400Q(a); Notice 2005-92, 2005-2 C.B. 1165.

60 Sec. 1400Q(c), as modified by the Heartland Disaster Tax Relief Act of 2008, P.L. 110-343, §702.

61 Secs. 72(p)(1)(A) and (t)(1); Regs. Sec. 1.72(p)-1, Q&A-1(a).

62 Sec. 72(p)(1)(B); Regs. Sec. 1.72(p)-1, Q&A-1(b).

63 Sec. 72(p)(5).

64 Sec. 72(m)(5).

65 Sec. 72(m)(5)(C). These include any person who owns more than 5% of the outstanding stock of a corporation or possesses stock with more than 5% of the combined voting power or who owns more than a 5% capital or profits interest.

66 Secs. 72(t)(9) and 457(a)(2).

67 Sec. 72(t)(2).

taxpayer is at least age 55 during the calendar year of retirement.[68] However, as with qualified plans, the triggering age under a defined benefit plan is 50 for qualified public safety employees of a state or local government.[69] As noted above, qualified public safety employees include police officers, firefighters, and medical emergency workers.[70]

The QDRO Payment Exception

The penalty does not apply to payments to a spouse, former spouse, child, or other dependent under a QDRO.[71] Note that QDROs under eligible state or local plans are subject to the less stringent qualification requirements applicable to qualified government plans. Nevertheless, if a domestic relations order still does not qualify, payments under the order will be subject to the early distribution penalty if no other exception applies.[72]

Other Specific Exceptions

Other plan payments and distributions not subject to the early distribution penalty tax include:

- Payments to the federal government due to lien, levy, garnishment, or seizure.[73]
- Certain distributions to victims of the 2005 hurricanes Katrina, Rita, and Wilma[74] and victims of the 2008 midwestern area storms, tornados, and flooding.[75]
- Distributions not exceeding the allowable amount of a retiree's itemized medical deductions for the tax year of the distributions (whether or not the retiree actually itemizes deductions).[76]

Generally, the three exceptions listed above are subject to the same rules as the similar exceptions discussed above for qualified plans.

Plan Loans to Taxpayers or Beneficiaries

As with qualified plans, loans to a taxpayer or beneficiary from an eligible state or local plan are generally taxable as distributions unless they satisfy the statutory requirements for qualified residential loans or qualified five-year term loans. Thus, nonqualified loans are subject to the penalty tax on premature distributions if none of the usual statutory exceptions applies.[77] The other rules applicable to loans and assignment under qualified plans also generally apply to eligible state or local plans.

Additional Exceptions for IRAs

The following exceptions to the early distribution penalty apply specifically to IRA distributions (in addition to the general exceptions initially discussed above).

Exception for First-Time Homebuyers

The penalty does not apply to certain qualified distributions to a taxpayer for the benefit of a first-time homebuyer. However, the tax law allows the taxpayer no more than $10,000 of such homebuyer distributions during his or her lifetime. The taxpayer's spouse is also entitled to $10,000 of such penalty-free distributions from his or her own IRAs. The tax law applies this exception after applying all other exceptions.[78]

To qualify, the taxpayer has 120 days after the distribution to pay the distributed funds for the purchase or construction of the homebuyer's principal residence (closing costs included). Upon cancellation or delay of the purchase or construction, the taxpayer may roll over the distribution tax free to an IRA, provided he or she completes the rollover within the same 120-day period.[79]

The first-time homebuyer can be the taxpayer, his or her spouse, or the child, grandchild, or ancestor of the taxpayer or spouse. To qualify, the homebuyer (and his or her spouse) must not have had an ownership interest in a principal residence during the two years immediately preceding the date of a binding purchase contract or the start of construction. Note, though, that a homebuyer might not qualify if he or she is in the U.S. military, or living outside the United States, on the day before the taxpayer applies the distribution to the purchase or construction.[80]

Exception for Higher Education Expenses

The penalty does not apply to distribution amounts not exceeding payments by the taxpayer for qualified education expenses at an eligible education institution. The expenses must be those of the taxpayer, his or her spouse, or their children or grandchildren.[81] This exception applies only to the extent of qualified education expenses for the year of the

68 Sec. 72(t)(2)(A)(v); Notice 87-13, Q&A-20.
69 Sec. 72(t)(10)(A).
70 Sec. 72(t)(10)(B).
71 Sec. 72(t)(2)(C).
72 Secs. 414(p)(11) and (p)(1)(A)(i); 29 U.S.C. §§1003(b)(1)–(2).
73 Sec. 72(t)(2)(A)(vii); *Hosking*, 567 F.3d 329 (7th Cir. 2009); *Murillo*, T.C. Memo. 1998-13, *acq.*, 1999-1 C.B. 332; IRS Letter Ruling 200426027 (6/25/04).
74 Sec. 1400Q(a).
75 Sec. 1400Q(c), as modified by the Heartland Disaster Tax Relief Act of 2008 §702.
76 Sec. 72(t)(2)(B).
77 Secs. 72(p)(1)(A), (p)(2), (p)(4)(A)(ii), (p)(4)(B), and (t)(1); Regs. Sec. 1.72(p)-1, Q&A-11(b).
78 Secs. 72(t)(2)(F) and (t)(8); Notice 98-49, 1998-2 C.B 365, Q&A C-2.
79 Sec. 72(t)(8).
80 Secs. 72(t)(8)(A) and (D).
81 Secs. 72(t)(2)(E) and (t)(7).

distribution and not to such expenses for other years.[82]

Observation: It is unclear whether a taxpayer must use the cash basis or the accrual basis to determine the year of an educational expense (or whether the taxpayer may choose the method to use).

Qualified education expenses generally include tuition, fees, books, supplies, equipment, and, in most cases, room and board—reduced for certain scholarships, allowances, and nontaxable payments.[83] Eligible education institutions include colleges and universities but do not include elementary or secondary schools.[84] The tax law applies the education expense exception after all exceptions other than the first-time homebuyer exception discussed immediately above.

Exception for Medical Insurance Premiums of an Unemployed Taxpayer

The penalty generally does not apply to IRA distributions to a taxpayer who receives unemployment compensation, but only to the extent the distributions do not exceed medical insurance premiums paid during the year. The medical insurance may not cover anyone other than the taxpayer, the taxpayer's spouse, and certain dependents.[85]

To qualify for the exception, the taxpayer must receive the unemployment compensation for 12 consecutive weeks. In addition, the taxpayer must receive the distributions in the same tax year that he or she receives unemployment compensation, or the following year. However, the taxpayer cannot receive the distributions later than 60 days after reemployment.[86]

A self-employed individual may qualify for the exception if he or she receives unemployment compensation, or would have hypothetically received unemployment compensation if not self-employed.[87]

Distributions Not Exceeding Itemized Medical Deductions

The penalty tax does not apply to distributions that do not exceed a taxpayer's allowable itemized medical deductions for the tax year of the distributions (whether or not the taxpayer itemizes deductions).[88] This exception is generally subject to the same restrictions applicable to the similar exception discussed above for employer retirement plans.

However, the tax law applies the medical expense exception to IRA distributions before the first-time homebuyer and education exceptions. Note that unlike the medical exception, the latter two exceptions are not available for employer retirement plans. Thus, in some circumstances a taxpayer may wish to use the medical expense exception first against distributions from employer retirement plans, in order to use more of the homebuyer and education exceptions against IRA distributions. Unfortunately, it is not clear whether the taxpayer has such discretion.

Other Specific Exceptions

Other IRA distributions not subject to the penalty tax include:

- Payments to the federal government due to lien, levy, garnishment, or seizure;[89]
- Distributions to certain military reservists called to active duty;[90] and
- Certain distributions to victims of the 2005 hurricanes Katrina, Rita, and Wilma[91] and victims of the 2008 midwestern area storms, tornados, and floods.[92]

These three exceptions generally are subject to the same restrictions as the similar exceptions discussed above for qualified plans.

Other Attributes of the Homebuyer, Education, and Medical Expense Exceptions

A taxpayer may receive a distribution qualifying for the homebuyer, educational, or medical expense exceptions even though the taxpayer is also receiving substantially equal periodic payments. In such a case, the additional distribution does not constitute a modification of the substantially equal payments that will trigger a retroactive early distribution penalty.[93] Furthermore, a taxpayer need not waste these qualifying expenses by offsetting them against the portion of a distribution constituting tax-free recovery of investment.[94]

Rollovers of Decedent's IRA or Plan Funds

A beneficiary who is a surviving spouse may roll over funds to his or her own IRA from the deceased spouse's qualified plan, TSA, eligible state or local plan, or IRA. If the surviving spouse does so, the tax law treats the surviving spouse as the recipient IRA's owner for purposes of applying the early distribution penalty (and exceptions) to distributions from the recipient IRA.[95]

Alternatively, the surviving spouse may roll the funds over to a new IRA in the decedent's name. Similarly, a nonspouse beneficiary may authorize a trustee-to-trustee transfer to a new IRA in the decedent's name. In either such case, the early distribution penalty does not apply since the exception for the death of an owner protects distributions by the recipient IRA.[96]

Investments in Collectibles by IRAs

The acquisition of a so-called collectible by an IRA is subject to harsh treatment for tax purposes. A taxpayer or beneficiary must treat the cost or value

82 *Lodder-Beckert*, T.C. Memo. 2005-162; *Duronio*, T.C. Memo. 2007-90.
83 Secs. 25A(g)(2) and 529(e)(3); *Nolan*, T.C. Memo. 2007-306.
84 Sec. 529(e)(5); *Nolan*, T.C. Memo. 2007-306.
85 Sec. 72(t)(2)(D).
86 Id.
87 Sec. 72(t)(2)(D)(iii).
88 Sec. 72(t)(2)(B).
89 Sec. 72(t)(2)(A)(vii); *Hosking*, 567 F.3d 329 (7th Cir. 2009); *Murillo*, T.C. Memo. 1998-13, *acq.*, 1999-1 C.B. 332; IRS Letter Ruling 200426027 (6/25/04).
90 Sec. 72(t)(2)(G).
91 Sec. 1400Q(a); Notice 2005-92.
92 Sec. 1400Q(a), as modified by the Heartland Disaster Tax Relief Act of 2008 §702.
93 Secs. 72(t)(2)(B) and (E); *Benz*, 132 T.C. 330 (2009).
94 *Argyle*, T.C. Memo. 2009-218.
95 Regs. Sec. 1.408-8, Q&A-5; *Gee*, 127 T.C. 1 (2006).
96 IRS Letter Rulings 200650023 (12/15/06) and 200450057 (12/10/04).

of the collectible as an immediate taxable distribution.[97] Thus, the distribution may be subject to the 10% penalty tax on premature distributions if an exception to the penalty does not apply. Collectibles generally include works of art, rugs, antiques, gems, stamps, alcoholic beverages, coins, metals, and other types of property designated by the IRS.[98]

Prohibited Transactions with IRAs

The tax law prohibits certain transactions between (1) a taxpayer or his or her beneficiaries and (2) the taxpayer's IRAs. An individual retirement account will terminate when such a prohibited transaction occurs. The tax law then treats the taxpayer or beneficiary as if he or she had received a taxable distribution of all the assets in that account. Fortunately, the prohibited transaction does not affect other of the taxpayer's untainted IRAs.[99]

In any event, the penalty for premature distributions may apply to the deemed distribution from the individual retirement *account* in the absence of an exception. On the other hand, prohibited transactions involving an individual retirement *annuity* are generally subject to a separate 15% penalty applicable to such transactions.[100]

IRA Loans and Pledges

A taxpayer may be able to pledge his or her interest in an individual retirement account for a loan that is not a prohibited transaction. If so, the taxpayer is subject to tax only on the amount pledged, as if the account had distributed that amount.[101] On the other hand, if a taxpayer borrows money under an individual retirement annuity or pledges a portion as security for a loan, the taxpayer must include in gross income the annuity's entire fair market value.[102] In either such case, the 10% penalty for premature distributions may apply to the taxable amount, in the absence of an exception.[103]

Harsher Penalty for Simple IRAs

A 25% early distribution penalty (in lieu of the 10% penalty) may apply to the taxable portions of distributions from a simple IRA. The greater penalty applies to distributions during the two-year period following a taxpayer's first participation in the simple IRA, unless one of the exceptions discussed above applies. For this purpose, a retiree begins participation in a simple IRA on the day the sponsoring employer makes the first contribution.[104]

Additional Exceptions for Roth IRAs

The penalty on premature distributions does not apply to a qualified distribution from a Roth IRA. To qualify, a distribution must generally satisfy two basic conditions. First, the Roth IRA must make the distribution after the taxpayer reaches age 59½, dies, or is disabled. Second, it must make the distribution after a five-year period beginning with the year of the taxpayer's first Roth IRA contribution.

On the other hand, the penalty may apply to all or a portion of a *nonqualified* distribution. That is, the penalty may apply to the portion of a nonqualified distribution paid from funds attributable to previously taxed components of qualified rollover contributions. The penalty may also apply to the portion of a nonqualified distribution paid from Roth IRA income and other accretions.[105] Nevertheless, the taxpayer or beneficiary will not be subject to the penalty tax if a statutory exception applies. For this purpose, the exceptions discussed above for IRA distributions also generally apply to nonqualified distributions from Roth IRAs.

In addition, a special exception to the penalty tax may apply to the portion of a nonqualified distribution that a Roth IRA pays from the previously taxed component of a qualified rollover contribution. This component will not be subject to the penalty if enough time has elapsed since the original qualified rollover contribution. The elapsed time is sufficient if the Roth IRA made its nonqualified distribution after the five-year period beginning with the first day of the tax year of the qualified rollover contribution.[106]

The five-year period discussed in the preceding paragraph is separately determined, and may be different, for each previous qualified rollover contribution. Furthermore, these five-year periods are not necessarily the same as the five-year period taken into account in determining whether a Roth IRA distribution is a qualified distribution.

Additional Exceptions for Designated Roth Accounts

The early distribution penalty does not apply to a qualified distribution from a designated Roth account. For this purpose, the tax law defines a qualified distribution from a designated Roth account somewhat similarly to a qualified distribution from a Roth IRA. The penalty also does not apply to a taxpayer's tax-free transfer of funds from a designated Roth account to a Roth IRA or to another designated Roth account.[107]

On the other hand, the penalty may apply to a nonqualified distribution that is not transferred to a Roth IRA or another designated Roth account.[108] For such a distribution, the amount of the penalty and the availability of exceptions are determined under the rules generally applicable to distributions from qualified plans and TSAs. However, the taxpayer must compute the penalty separately for the distribution, as if the designated Roth account were a separate plan.[109]

Additional Exceptions for Funded Nonqualified Plans

Penalty exceptions available for distributions from a funded nonqualified plan differ depending on whether the plan was formerly a qualified plan, TSA, or eligible

97 Secs. 408(m)(1), 408(d)(1), and 72(e).
98 Secs. 408(m)(2) and (3).
99 Secs. 72(t), 408(e)(2), and 4975(c)(3); IRS Letter Ruling 9725029 (6/20/97).
100 Secs. 72(t), 408(e)(2)(B), and 4975(a), (c), and (e).
101 Sec. 408(e)(4).
102 Sec. 408(e)(3); Regs. Sec. 1.408-3(c).
103 Sec. 72(t).
104 Sec. 72(t)(6); Notice 98-4, 1998-1 C.B. 269.
105 Secs. 72(t)(1) and 408A(d); Regs. Sec. 1.408A-6, Q&A-5.
106 Sec. 408A(d)(3)(F); Regs. Sec. 1.408A-6, Q&A-5.
107 Secs. 72(t)(1) and 402A(c)(3)(A); Regs. Sec. 1.402A-1, Q&A-5.
108 Sec. 72(t)(1).
109 Regs. Sec. 1.402A, Q&A-3.

state or local plan. If the plan was formerly such a plan, the penalty and the exceptions to the penalty apply as if the plan were now a qualified plan (but not a TSA or eligible state/local plan).

Contributions or rollovers into a plan or IRA after it starts substantially equal payments will constitute a modification that triggers the penalty tax.

Exceptions for Formerly Qualified Plans

In addition to the more generally applicable exceptions initially discussed in this article, the penalty does not apply to the following distributions from plans that were formerly qualified plans, TSAs, or eligible state or local plans:[110]

- Distributions after retirement if the taxpayer is at least age 55 during the calendar year of retirement, or age 50 for a public safety employee participating in a defined benefit plan of a state or local government;[111]
- Payments to the federal government due to lien, levy, garnishment, or seizure;[112] or
- Distributions not exceeding the allowable amount of a taxpayer's itemized medical deductions for the tax year of the distributions (whether or not the taxpayer itemizes deductions).[113]

Generally, the exceptions listed above are subject to the same rules as the similar exceptions discussed above for qualified plans.

Observation: The exception to the early distribution penalty for QDROs does not appear to apply to formerly qualified plans, TSAs, or eligible state or local plans. The tax definition of QDROs appears to limit their use to existing qualified plans, TSAs, and eligible state/local plans. However, it is arguable that the exception should be available for payments under a QDRO properly established *before* the disqualification of a plan.[114]

Funded Nonqualified Plans from Inception

The generally applicable exceptions initially discussed above also apply to plans funded by trusts or annuities that have been nonqualified plans from their inception. In addition, the following specific exceptions apply to such plans:[115]

- Payments under an annuity contract (1) purchased with a single premium, (2) providing for substantially equal annuity payments, and (3) with an annuity starting date no later than one year after purchase.[116]
- Payments allocable to the taxpayer's investment in the plan before August 14, 1982, including any income accumulated on the investment. The tax law allocates payments to pre–August 14, 1982, investment before allocating them to post–August 13, 1982, investment.[117]

Plan Loans to Taxpayers or Beneficiaries

Loans made from a plan that was formerly a qualified plan, TSA, or eligible state or local plan are not subject to the penalty if they are qualified residential loans or qualified five-year term loans. Other loans to a taxpayer or beneficiary from a funded nonqualified plan are generally taxable as distributions (regardless of the plan's former status). Thus, nonqualified loans are subject to the penalty tax on premature distributions if none of the usual statutory exceptions applies.[118]

Similarly, the portion of a plan interest the taxpayer or beneficiary assigns or pledges as security for a nonqualified loan is subject to penalty,[119] as are nonqualified loans, assignments, or pledges under annuities purchased by the plan.[120]

Additional Exceptions for Personally Purchased Annuities

In addition to the generally applicable exceptions initially discussed above, the following specific exceptions to the penalty apply to distributions under personally purchased annuities:[121]

- Payments under an annuity contract (1) purchased with a single premium, (2) providing for substantially equal annuity payments, and (3) with an annuity starting date no later than one year after purchase.[122]
- Payments under certain annuity contracts funding personal injury judgments or settlements.[123]
- Payments allocable to investment in the contract before August 14, 1982, including any income accumulated on the investment. The tax law allocates payments to pre–August 14, 1982, investment before allocating them to post–August 13, 1982, investment.[124]

Tax-Free Exchange of Annuities

A taxpayer may exchange all or part of his or her personally purchased annuity contract for a new annuity contract without incurring tax on the exchange,

110 Secs. 72(t)(1) and 4974(c); *Montgomery*, T.C. Memo. 1996-263.
111 Secs. 72(t)(2)(A)(v) and (t)(10); Notice 87-13, Q&A-20.
112 Sec. 72(t)(2)(A)(vii); *Hosking*, 567 F.3d 329 (7th Cir. 2009); *Murillo*, T.C. Memo. 1998-13, *acq.*, 1999-1 C.B. 332; IRS Letter Ruling 200426027 (6/25/04).
113 Sec. 72(t)(2)(B).
114 Secs. 72(t)(2)(C), 401(a)(13), 403(a)(1), 404(a)(2), 414(p)(9), and 414(p)(11).
115 Sec. 72(q)(2).
116 Secs. 72(q)(2)(I) and (u)(4).
117 Sec. 72(q)(2)(F); Rev. Rul. 85-159, 1985-2 C.B. 29.
118 Secs. 72(p)(1)(A) and (t)(1); Regs. Sec. 1.72(p)-1, Q&A-1(a).
119 Sec. 72(p)(1)(B); Regs. Sec. 1.72(p)-1, Q&A-1(b).
120 Sec. 72(p)(5).
121 Sec. 72(q)(2).
122 Secs. 72(q)(2)(I) and (u)(4).
123 Sec. 72(q)(2)(G).
124 Sec. 72(q)(2)(F); Rev. Rul. 85-159.

if certain conditions are satisfied.[125] However, if the taxpayer receives cash or other property in addition to the new annuity contract, gain on the old annuity contract is taxable to the extent of the cash and the value of the other property received.[126] The taxable gain may then be subject to the penalty tax on early distributions if none of the usual exceptions applies.

Other Generally Applicable Considerations

As more fully discussed below, the early distribution penalty generally applies to distributions of rollover funds, involuntary distributions, distributions for financial hardship, and deemed distributions.

Rollover Funds in a Recipient Plan or IRA

The penalty rules and exceptions applicable to a particular plan or IRA also generally apply to distributions by the plan or IRA of funds previously rolled over to it. Thus, for example, distributions by a qualified plan of funds previously rolled over from an IRA are generally subject to the penalty rules and exceptions applicable to qualified plans, and not those applicable to IRAs.[127] (Take note, though, of the different rule discussed above applicable to funds rolled over to an eligible state or local government plan.)

Involuntary Distributions

Except for certain federal government liens, levies, garnishments, and seizures discussed above, the early distribution penalty applies without regard to whether a distribution is voluntary or involuntary. For example, IRA funds distributed to a taxpayer in liquidation of an insolvent financial institution were subject to the penalty when the taxpayer failed to roll them over to another IRA. Similarly, the Tax Court has imposed the penalty on a distribution taken by a divorced taxpayer to gain his release from prison (by using the distribution to pay delinquent alimony and child support).[128]

Personal or Financial Hardship

A mere claim of personal or financial hardship will not eliminate the penalty, regardless of the severity of the hardship. For example, the Tax Court applied the penalty to distributions necessary for the "subsistence" of the taxpayer and her family. The Tax Court similarly applied the penalty to distributions for the support of a husband and wife who both had unexpectedly lost their jobs.[129]

Deemed Distributions

Deemed distributions include nonqualifying plan loans, terminations of IRAs due to prohibited transactions, impermissible employee stock ownership plan (ESOP) accruals and allocations, etc. In many ways, the tax law treats a deemed distribution as an actual distribution. For example, the distribution is taxable to the extent it exceeds the recovery of taxpayer investment. In addition, the early distribution penalty applies to the taxable portion, in the absence of an exception.[130]

Deemed distributions do not include a plan's payments of the cost of life insurance. Those payments are simply included in a participant's gross income without any tax-free recovery of investment.[131] As discussed above, the early distribution penalty does not apply to such payments.

Conclusion and Planning

In summary, then, the 10% penalty tax may apply to distributions that a qualified plan, TSA, or designated Roth account makes to a taxpayer before retirement or after early retirement. More specifically, the penalty may apply to the taxable portions of such distributions if a taxpayer is under age 59½ and is still employed or had previously retired before the year he or she attained age 55.

The same general rule applies to distributions received from funds previously rolled over to an eligible state or local plan from a qualified plan, TSA, or IRA. Furthermore, this treatment applies to distributions received from certain funded nonqualified plans that were formerly qualified plans, TSAs, or eligible state or local plans. If the taxpayer is under age 59½ (whether or not retired), the penalty tax will also potentially apply to the taxable portions of distributions from other types of employer retirement plans, IRAs, Roth IRAs, and personally purchased annuities.

Nevertheless, a number of exceptions to the penalty tax may be available, even if the taxpayer is under the ages specified above. For example, the penalty tax does not apply to distributions after a taxpayer's death or disability, regardless of the taxpayer's age. Nor does the penalty apply to tax-free rollovers from one tax-favored employer retirement plan or IRA to another such plan or IRA. Other exceptions potentially apply to (1) QDRO payments, (2) federal government levies, (3) military reservist distributions, (4) ESOP dividend distributions, and (5) medical, education, or homebuyer payments.

Avoiding the Penalty Using Substantially Equal Periodic Payments

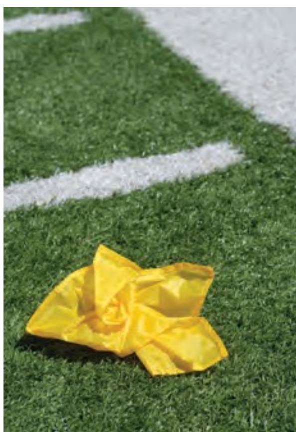
If other exceptions are not available, a taxpayer might nevertheless avoid the penalty by arranging to receive substantially equal periodic payments annually or more frequently. The taxpayer and his or her beneficiary must receive the payments over:

- The taxpayer's lifetime;
- The joint lifetimes of the taxpayer and the beneficiary;
- A period equal to the taxpayer's life expectancy; or
- A period equal to the joint life expectancies of the taxpayer and the beneficiary.

125 Sec. 1035(a)(3); Regs. Sec. 1.1035-1.
126 Sec. 1031(b).
127 Rev. Rul. 2004-12, 2004-1 C.B. 478.
128 *Aronson*, 98 T.C. 283 (1992); *Baas*, T.C. Memo. 2002-130.
129 *Milner*, T.C. Memo. 2004-111; *Robertson*, T.C. Memo. 2000-100.
130 Regs. Secs. 1.72(p)-1, Q&A-11, and 1.409(p)-1(b)(2); IRS Letter Ruling 9725029 (6/20/97).
131 Regs. Sec. 1.72-16(b)(2).

A taxpayer has almost complete control of the amount of funds used to compute the substantially equal payments. For example, a taxpayer may transfer a portion of plan funds or IRA funds tax free to another plan or IRA before commencing such payments from the remaining account balance. In the case of a qualified plan, TSA, or eligible state or local plan, the outbound transfer need only be in connection with the commencement of payments.

A taxpayer also has considerable flexibility in combining and separating substantially equal IRA payments. A taxpayer with several IRAs may compute such payments for two or more of them in the aggregate, and may make the aggregate payments from any one or more of the covered IRAs. Or a taxpayer may adopt at various times separate streams of payments from different IRAs, using different safe-harbor methods of computation.



Of course, as more fully discussed above, the penalty tax generally will apply retroactively if the taxpayer modifies the arrangement within five years after the first payment or before he or she reaches age 59½, whichever is later. Note, though, that the IRS has ruled that transfer of a portion of the account balance of a plan or IRA to a spouse in a divorce proceeding will not constitute a modification. However, the transferring taxpayer must reduce his or her payments to take into account the reduced account balance.

Avoiding the Penalty by Purchasing a Single-Premium Immediate Annuity

In the absence of other exceptions, a taxpayer may still avoid the penalty on a personally purchased annuity contract if it contains certain provisions. The contract must require a single premium payment, provide for substantially equal annuity payments, and begin within one year of purchase. Thus, the taxpayer may receive penalty-free annuity payments for initial early retirement years (i.e., before reaching age 59½) if he or she purchases an annuity contract with these features within the one-year period preceding retirement.

IRA Funds Transferred to an Employer Plan to Avoid the Penalty

If a taxpayer retires when he or she is under age 59½ but over age 55, the taxpayer might be able to avoid the penalty tax on distribution of IRA funds by transferring the funds tax free to a qualified plan, TSA, or eligible state or local plan and by taking distributions from the plan.[132] Of course, the taxpayer would have to be a participant in a plan willing to accept transfers from IRAs.

Observation: In addition, the taxpayer should carefully consider potential application of the step-transaction or economic substance doctrines.[133] For example, the IRS would likely disregard a taxpayer's transfer of funds from an IRA to a qualified plan if the qualified plan immediately distributed all the transferred funds to the taxpayer.

IRA Conversion While Receiving Substantially Equal Periodic Payments

A taxpayer receiving substantially equal periodic payments from an IRA to avoid the penalty tax must necessarily be careful about modifications that could trigger retroactive penalties and interest. Fortunately, though, conversion of the entire IRA to a Roth IRA (as a qualified rollover contribution) will not trigger retroactive penalties, provided the Roth IRA continues to make the substantially equal payments.

Thus, an IRA's substantially equal payments should not adversely affect a decision to convert an IRA to a Roth IRA, provided the conversion otherwise makes sense. It is true that some of the substantially equal payments made by the Roth IRA after the conversion may be includible in gross income, at least until the taxpayer reaches age 59½ and perhaps for a few years after that. However, the includible amount should be smaller than before the conversion.

Observation: It is unclear, however, whether the IRA conversion constitutes a forbidden modification if the recipient Roth IRA holds unrelated funds. It is also unclear under what circumstances a taxpayer may make a qualified rollover contribution to a Roth IRA from a qualified plan, TSA, or eligible state or local plan without triggering the retroactive penalty.

Retention or Transfer of Investment in the Plan

When a taxpayer rolls over to an IRA a distribution of the entire balance in a qualified plan, the taxpayer may personally retain the portion of the distribution that is a recovery of his or her investment. Neither the amount rolled over nor the retained investment is subject to tax or to the penalty on early distributions. The taxpayer may accomplish the same thing in a trustee-to-trustee transfer by directing the trustee to transfer to the IRA all funds in excess of the taxpayer's investment and distribute to the taxpayer the remaining funds equal to the investment.[134]

Young Surviving Spouse

A surviving spouse may roll over his or her interest in a qualified plan to an IRA either in the spouse's name as owner or in the name of the decedent. However, the surviving spouse generally should not roll over the plan interest to an IRA

132 Rev. Rul. 2004-12; IRS Letter Ruling 200453026 (12/31/04).

133 *Minn Tea Co. v. Helvering*, 302 U.S. 609 (1938); *Penrod*, 88 T.C. 1415 (1987); Health Care and Education Reconciliation Act of 2010, P.L. 111-152, §1409 (adding Sec. 7701(o)).

134 Regs. Sec. 1.401(a)(31)-1, Q&A-9.

in his or her own name if the spouse is under age 59½ and is likely to need funds for personal use before age 59½. If the surviving spouse transfers the funds to his or her own IRA in these situations, distributions before he or she reaches age 59½ will be subject to the early distribution penalty, unless one or more exceptions apply.

On the other hand, the penalty tax will not apply if the surviving spouse rolls over his or her interest in a qualified plan to an IRA in the name of the decedent (with the spouse as a mere beneficiary). In that case, IRA distributions are excepted from the penalty by reason of the death of the plan participant.[135] Of course, the surviving spouse may always choose to assume ownership of the IRA later, after reaching age 59½.[136]

Retention of Documents and Other Evidence

It is important to retain all documents supporting an exception to the penalty. Unfortunately, the courts frequently find that taxpayers have offered inadequate evidence to prove the applicability of an exception to the penalty.[137] For example, the receipt of private disability insurance payments and the uncorroborated testimony of the taxpayer have been insufficient to support application of the disability exception.[138]

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EditorNotes

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135 Sec. 72(t)(2)(A)(ii); IRS Letter Ruling 200450057 (12/10/04).

136 Regs. Sec. 1.408-8, Q&A-5(a); IRS Letter Ruling 200940031 (10/2/09).

137 *Hughes*, T.C. Memo. 2008-249; *Banister*, T.C. Memo. 2008-201; *Cabirac*, T.C. Memo. 2008-142.

138 *Kowsh*, T.C. Memo. 2008-204.