taxnotes federal

Volume 171, Number 10 ■ June 7, 2021

Birth or Adoption Exception to the Early Retirement Distribution Penalty

by Vorris J. Blankenship

Reprinted from *Tax Notes Federal*, June 7, 2021, p. 1541

Birth or Adoption Exception to the Early Retirement Distribution Penalty

by Vorris J. Blankenship

Vorris J. Blankenship

Vorris J. Blankenship is a retired attorney and CPA and the author of *Tax Planning for Retirees*.

In this article, Blankenship explores the requirements and consequences of the qualified birth or adoption exception to the 10 percent penalty on early distributions from tax-favored retirement plans under the Setting Every Community Up for Retirement Enhancement Act.

The Setting Every Community Up for Retirement Enhancement (SECURE) Act (P.L. 116-94) added a new exception to the 10 percent penalty on early distributions from tax-favored retirement plans. The exception applies to distributions following the birth or adoption of a child. This article explores the requirements and consequences of the exception. First, however, it will be helpful to provide context by briefly acknowledging the other exceptions to the penalty.

I. Exceptions to the Early Distribution Penalty

The 10 percent early distribution penalty generally applies to distributions from tax-favored retirement plans for participants who have not yet reached age 59½. Tax-favored retirement plans for this purpose mean qualified plans, IRAs, section 403(b) plans, and section 457 government plans (to the extent that the 457 plans hold funds rolled over from other types of plans).[1] Exceptions to the imposition of this early distribution penalty include:

1. distributions to a participant after he becomes disabled;[2]
2. substantially equal periodic payments to a participant received annually or more frequently (but for an employer plan, only if the payments begin after separation from service);[3]
3. post-retirement distributions from an employer plan received by a participant who was at least 55 during the calendar year of retirement (50 for some qualified public safety employees);[4]
4. payments from an employer plan to a spouse, former spouse, child, or other dependent of a participant under a qualified domestic relations order;[5]
5. a portion of aggregate distributions that is less than or equal to a participant's allowable itemized medical deductions;[6]
6. distributions to beneficiaries or to a participant's estate after the death of the participant;[7]
7. the proceeds of employer plan loans that are qualified residential loans or qualified five-year term loans;[8]

[1] Sections 72(t)(1) and (9), 4974(c).
[2] Section 72(t)(2)(A)(iii).
[3] Section 72(t)(2)(A)(iv) and (3)(B).
[4] Section 72(t)(2)(A)(v); Notice 87-13, 1987-1 C.B. 432, Q&A 20.
[5] Sections 72(t)(2)(C) and 414(p).
[6] Sections 72(t)(2)(B) and 213(a).
[7] Section 72(t)(2)(A)(ii).
[8] Section 72(t)(1).

8. the portion of a distribution that is a nontaxable return of the taxpayer's investment;[9]
9. the portion of a distribution rolled over tax free to another plan or IRA;[10]
10. qualified rollover contributions to a Roth IRA or a designated Roth account (Roth conversions);[11]
11. "qualified distributions" from a Roth IRA or a designated Roth account;[12]
12. the inclusion in a participant's gross income of life insurance costs paid by an employer plan;[13]
13. plan payments to the federal government resulting from lien, levy, garnishment, or seizure;[14]
14. distributions from funds in a 457 government plan (if the funds were not rolled over from another type of plan);[15]
15. payment of dividends on employer stock held by an employee stock ownership plan;[16]
16. qualified military reservist distributions from an employer plan (except a 457 government plan);[17]
17. qualified distributions to a participant for the benefit of first-time homebuyers (IRAs only);[18]
18. distribution amounts not exceeding payments by the participant for qualified education expenses at an eligible education institution (IRAs only);[19]
19. distributions to a participant who receives unemployment compensation, to the extent that the distributions do not exceed medical insurance premiums paid during the year (IRAs only);[20] and
20. specific distributions to taxpayers who were victims of (1) the 2005 hurricanes Katrina, Rita, and Wilma;[21] (2) the 2008 Midwestern storms, tornados, and flooding;[22] (3) the 2017 hurricanes Harvey, Irma, and Maria;[23] (4) the 2016 disasters;[24] (5) the 2017 California wildfires;[25] (6) the qualified disaster areas declared from January 1, 2018, to December 20, 2019;[26] (6) the 2020 coronavirus pandemic;[27] and (7) the qualified disaster areas declared from January 1, 2020, to February 25, 2021.[28]

The SECURE Act added the qualified birth or adoption (QBA) exception to the above-listed exceptions.[29]

II. Permitted Birth or Adoption Distributions

Under the QBA exception, the early distribution penalty does not apply to QBA distributions that are permitted by an eligible plan.[30] Eligible plans, for this purpose, are tax-favored retirement plans (including IRAs) that are not defined benefit plans.[31] Thus, QBA distributions may be permitted by qualified defined contribution plans, 403(b) plans, 457

[9] *Id.*

[10] *Id.*

[11] Sections 402A(c)(4)(A)(ii) and 408A(d)(3)(A)(ii).

[12] Sections 72(t)(1), 408A(d)(1) and (2).

[13] Reg. section 1.72-16(b)(2); Notice 89-25, 1989-1 C.B. 662, Q&A 11; prop. reg. section 1.403(b)-6(g).

[14] Section 72(t)(2)(A)(vii); *United States v. Hosking*, 567 F.3d 329 (7th Cir. 2009); *Murillo v. Commissioner*, T.C. Memo 1998-13, *acq.*, 1999-4 IRB 4; LTR 200426027.

[15] Sections 72(t)(9) and 457(a)(2).

[16] Section 72(t)(2)(A)(vi); Notice 2002-2, 2002-1 C.B. 285, Q&A 7.

[17] Section 72(t)(2)(G).

[18] Section 72(t)(2)(F) and (t)(8); Notice 98-49, 1998-2 C.B. 365, Q&A C-2.

[19] Section 72(t)(2)(E) and (t)(7).

[20] Section 72(t)(2)(D).

[21] Section 1400Q(a); Notice 2005-92, 2005-2 C.B. 1165.

[22] Section 1400Q(c), as modified by the Heartland Disaster Tax Relief Act (P.L. 110-343), section 702.

[23] Disaster Tax Relief and Airport and Airway Extension Act of 2017 (P.L. 115-63), section 502.

[24] Tax Cuts and Jobs Act (P.L. 115-97), section 11028.

[25] Bipartisan Budget Act of 2018 (P.L. 115-123), sections 20101 and 20202.

[26] Taxpayer Certainty and Disaster Tax Relief Act of 2019 (P.L. 11694), sections 201-208.

[27] Coronavirus Aid, Relief, and Economic Security Act (P.L. 116-136), section 2103.

[28] Further Consolidated Appropriations Act, 2020 (P.L. 116-94), sections 301 and 302(a).

[29] SECURE Act section 113(a). For a more detailed explanation of the exceptions to the early distribution penalty, see Vorris J. Blankenship, "Retirement Plans, IRAs, and Annuities: Avoiding the Early Distribution Penalty," *The Tax Adviser*, Apr. 2011, at 254.

[30] Section 72(t)(2)(H)(i); Notice 2020-68, 2020-38 IRB 567, Q&A D-4.

[31] Section 72(t)(2)(H)(vi)(I). Defined benefit plans are generally plans that do not provide individual accounts for participants (or do not properly account for them). Section 414(i) and (j); reg. section 1.457-2(b)(3).

government plans, and IRAs.[32] The QBA exception is available for years after 2019[33] and applies to a maximum of $5,000 of aggregate distributions for each QBA.[34]

A QBA distribution is defined as a distribution permitted by the plan that is made within one year after the birth of the taxpayer's child or within one year after the taxpayer's final adoption of a child or disabled individual.[35] An adoptee must be either under 18 or physically or mentally incapable of self-support. For this purpose, an adoptee is physically or mentally incapable of self-support 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 adoptee will probably die. The adoptee may not, however, be the child of the taxpayer's spouse.[36]

The $5,000 limit applies separately to each parent for that parent's QBA distributions from his eligible plan.[37] For multiple births or adoptions, the $5,000 limit applies to each child born or adopted.[38]

A. Example

Assume that a married individual gives birth to twins. Assume that each parent is a participant in an eligible plan that permits QBA distributions. Then, each parent may take a QBA distribution up to the amount of $10,000 ($5,000 for each twin) for a total family distribution of $20,000.

The 20 percent income tax withholding normally applicable to eligible rollover distributions does not apply to QBA distributions.[39] Instead, the distributions are subject to ten percent withholding,[40] which the taxpayer may eliminate by giving the plan clear written instructions to do so.[41]

III. Recontributions of QBA Distributions

After a permitted QBA distribution, the taxpayer may recontribute an amount to an employer plan that is no more than the previous QBA distributions from the plan. However, to qualify for recontribution, the taxpayer must generally be eligible to make contributions to the plan, and the plan must be one that generally accepts rollovers.[42] The taxpayer may also recontribute all or part of the QBA distribution to her IRA, to the extent not previously recontributed to an employer plan.[43]

Recontribution to a plan or IRA of a QBA distribution previously received from a non-Roth plan or account is treated as a rollover of the distribution. If made to an employer plan or traditional IRA, the rollover is tax free. If made to a Roth IRA or a designated Roth account, the rollover is taxable as a Roth conversion. A QBA distribution from a Roth IRA or designated Roth account may also be rolled over, but not to a non-Roth plan or account. Most significantly, a QBA distribution is presumed to have been rolled over within 60 days of the distribution even if the recontribution occurs more than 60 days after the distribution.[44] The QBA distribution would, of course, be of limited value in providing for birth or adoption expense if it had to comply with the 60-day rollover requirement.

A. The One-IRA-Rollover Rule

For purposes of complying with the general rule allowing only one indirect IRA rollover within a one-year period (the one-rollover rule), a taxpayer may have to take into account a rollover

[32] Notice 2020-68, Q&A D-3.

[33] SECURE Act section 113(b).

[34] Section 72(t)(2)(H); Notice 2020-68, Q&A D-1. A permitted QBA distribution will not violate statutory constraints on the commencement of distributions from section 401(k) plans, section 403(b) plans, or section 457 government plans. Section 72(t)(2)(H)(vi)(IV); Notice 2020-68, Q&A D-14.

[35] Notice 2020-68, Q&A D-1. The taxpayer must include the name, age, and taxpayer identification number of the child or eligible adoptee on the taxpayer's tax return for the tax year in which the distribution is made. Notice 2020-68, Q&A D-2.

[36] Section 72(m)(7), 72(t)(2)(H)(iii)(I) and (II); Notice 2020-68, Q&A D-5, Q&A D-6.

[37] Notice 2020-68, Q&A D-7.

[38] *Id.* at Q&A D-8.

[39] Section 72(t)(2)(H)(vi)(II); *id.* at Q&A D-15.

[40] Sections 3405(b)(1) and (e)(1)(B)(i), 3401(a)(12)(A)-(B); reg. section 35.3405-1T.

[41] Section 3405(b)(2); reg. section 35.3405-1T, Q&A D-26.

[42] Section 72(t)(2)(H)(v)(I) and (II); Notice 2020-68, Q&A D-9 and D-13.

[43] Section 72(t)(2)(H)(v)(III) and (IV).

[44] Section 72(t)(2)(H)(v)(III) and (IV); Notice 2020-68, Q&A D-16 and D-17; Joint Committee on Taxation, "Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the 'Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019,'" JCX-13-19 at 46 (Apr. 2, 2019).

of a QBA distribution from a traditional IRA to another traditional IRA (or from a Roth IRA to a Roth IRA). Under the one-rollover rule, a taxpayer generally may *not* roll over a current IRA distribution to another IRA tax free if (1) the taxpayer received a previous distribution from any IRA during the one-year period preceding the current distribution, and (2) the taxpayer rolled over the previous distribution tax free to an IRA.[45]

It seems unlikely, although possible, that the one-rollover rule could invalidate the rollover of a QBA distribution. The QBA statutory language provides that the "distribution shall be treated as a [rollover distribution] and as having been transferred to the applicable eligible retirement plan in a direct trustee to trustee transfer within 60 days of the distribution."[46] Thus, a QBA distribution is to be treated as a rollover distribution even though it would not otherwise satisfy the definition of that type of distribution. It is a bit troubling, however, that the QBA statutory language expressly states that it overrides the 60-day rule but does not similarly mention the one-rollover rule. Thus, until there is IRS clarification, it may be advisable to delay a QBA distribution if that is necessary to avoid the possible nullifying effect of a rolled-over distribution received within one year *before* the QBA distribution.

Unfortunately, it is somewhat more likely that there is reason for a taxpayer to avoid the attempted rollover of a non-QBA distribution received within one year *after* a QBA distribution. The QBA statutory language does not change the requirements for such a subsequent non-QBA rollover. Thus, the non-QBA rollover attempt will be subject to the one-rollover rule and will likely be invalidated by the rollover of the previous QBA distribution (which, as indicated above, is treated as a rollover distribution). Note that the one-rollover rule may be difficult to apply to the subsequent non-QBA distribution because of the extended period allowed for rollover of the previous QBA distribution and the consequent long-term uncertainty of whether the QBA rollover will ever be consummated.

If, nevertheless, an intended second rollover could violate the one-rollover rule because the rollover of a previous QBA distribution must be taken into account, the taxpayer may be able to avoid the violation if the mistake is caught before the second rollover is fully consummated. Assume, for example, that a taxpayer rolls over QBA distribution 1 from a traditional IRA to another traditional IRA. Then, within one year of QBA distribution 1, the taxpayer receives distribution 2 from a traditional IRA also intending to roll over distribution 2 to a traditional IRA (in violation of the one-rollover rule). If the taxpayer discovers the error at that point, he or she may instead roll over distribution 2 to a Roth IRA, thus making the rollover a taxable Roth conversion that is not considered in applying the one-rollover rule.[47] True, the taxpayer does not avoid taxation of the distribution, but the taxpayer nevertheless enjoys the substantial benefits of a Roth IRA.

Alternatively, the taxpayer may roll over the before-tax portion of distribution 2 tax free to a consenting qualified plan, 403(b) plan, or 457 government plan.[48] These types of alternative rollovers are not taken into account in applying the one-rollover rule.[49] Of course, the taxpayer must accept the different consequences of alternative types of rollovers (for example, the inability to roll over employee investment to an employer plan and the taxability of a Roth conversion).[50]

B. Use If Penalty Not Applicable

Although the primary benefit of a permitted QBA distribution is avoidance of the early distribution penalty, a QBA distribution is defined independently of that penalty.[51] A distribution may meet the definition of a QBA distribution even if some other exception to the penalty (for example, the disability exception)

[45] *Bobrow v. Commissioner*, T.C. Memo. 2014-21. Section 408(d)(3)(B). Announcement 2014-15, 2014-16 IRB 973; Announcement 2014-32, 2014-48 IRB 907. For purposes of the one-rollover rule, IRAs include simplified employee pension plans and SIMPLE IRAs. Announcement 2014-32.

[46] Section 72(t)(2)(H)(v)(IV).

[47] Section 408A(e)(1)(B)(i).

[48] Section 408(d)(3)(A)(ii).

[49] Section 408(d)(3)(B).

[50] Section 408A(d)(3)(A)(i); LTR 200909074.

[51] Section 72(t)(2)(H)(iii).

would have otherwise avoided the penalty.[52] Thus, a taxpayer may disregard the usual 60-day rollover requirement and recontribute (roll over) a QBA distribution to an eligible plan whether or not the QBA classification was necessary to avoid the early distribution penalty.[53]

C. Distributions to Beneficiaries

A distribution to a beneficiary may qualify as a QBA distribution. The IRC states that an "individual" is eligible to receive QBA distributions, and, to state the obvious, both participants and beneficiaries are individuals.[54] Thus, a beneficiary receiving a QBA distribution may take advantage of the extended recontribution period if the beneficiary could otherwise have made a rollover to the recipient plan.[55] For example, a beneficiary who is the surviving spouse may roll over (recontribute) a QBA distribution to the same extent the participant could.[56] Although it is unlikely that a surviving spouse would want to recontribute the QBA distribution to the distributing employer plan, the surviving spouse may instead make the rollover (recontribution) to his IRA or to an IRA in the name of the deceased participant.[57]

Similarly, a non-spouse beneficiary receiving a QBA distribution from an employer plan may make a rollover (recontribution) of the distribution to a newly established inherited IRA. Although those rollovers are required to be direct trustee-to-trustee transfers, the IRC provides that a QBA distribution "shall be treated" as a direct trustee-to-trustee transfer.[58] On the other hand, there is no discernable benefit that a non-spouse beneficiary could derive from receiving a QBA distribution from an inherited IRA. That is, the early distribution penalty does not apply anyway after the death of the participant,[59] and a non-spouse beneficiary may *not* roll over (recontribute) any distribution from an inherited IRA to any other plan.[60]

A beneficiary generally may not roll over a QBA distribution that was received by the participant before the participant's death. The code limits recontributions to the "individual who receives a [QBA] distribution."[61] Nevertheless, the personal representative of the deceased participant may be able to make the recontribution.[62]

The SECURE Act did not just eliminate the 60-day rollover limitation for QBA distributions; it also did not set any other specific time limit on the completion of a QBA recontribution. In fact, the Joint Committee on Taxation stated that a taxpayer may make the recontribution to an eligible plan "at any time after the date on which the distribution was received."[63] The IRS has indicated, however, that it intends to issue regulations addressing the recontribution rules — particularly the timing of recontributions.[64] IRS concerns about this almost certainly revolve around the interaction of recontributions with the statute of limitations.

IV. Limits on Rollover Periods

If a taxpayer fails to include a taxable QBA distribution in gross income for the year of the distribution, the anticipated regulations are unlikely to allow a recontribution (rollover) of the distribution after the extended due date of the tax return for the year of the distribution. If the recontribution period is not so limited, the period of the statute of limitations for the year of distribution could later expire without the taxpayer either paying the tax on the distribution or making a recontribution of the distribution (that is, without completing the rollover). The IRS would not want to be caught in that position.

[52] Section 72(t)(2)(A)(iii).

[53] Section 72(t)(2)(A)(v).

[54] Section 72(t)(2)(A)(iii)(I).

[55] Section 72(t)(2)(A)(v)(I); Notice 2020-68, Q&A D-13.

[56] Sections 402(c)(9), 403(a)(4)(B) and (b)(8)(B), and 457(e)(16).

[57] Section 402(c)(1), (c)(5), and (c)(9); LTR 200450057; LTR 200940031; Notice 2008-30, 2008-12 IRB 638, Q&A 7. Although Notice 2008-30 deals with a spousal rollover contribution to a Roth IRA, the governing statutory section (section 402(c)) is the same as for a spousal rollover to a traditional IRA or other qualifying plan.

[58] Sections 402(c)(11), 403(a)(4)(B) and (b)(8)(B), 457(e)(16), and 72(t)(2)(H)(v)(III) and (IV).

[59] Section 72(t)(2)(A)(ii).

[60] Section 408(d)(3)(c)(i)(I).

[61] Section 72(t)(2)(H)(v)(I).

[62] *Gunther v. United States*, 573 F. Supp. 126 (W.D. Mich. 1982); LTR 200742027; LTR 200453018; LTR 200924056; LTR 200502050.

[63] JCT, *supra* note 44, at 46.

[64] Notice 2020-68.

Nevertheless, the regulations will hopefully recognize that the position of the IRS is generally not compromised if the rollover is completed before the extended due date of the tax return for the year of the distribution. If the rollover is tax free, it would then be clear that no tax is due for the year of the distribution.[65] Or if the rollover were instead a taxable Roth conversion, it would be clear by the due date of the return whether the taxpayer had failed to pay the tax on the conversion.

A. Recontribution Periods if the Tax Is Paid

If a taxpayer does not make a recontribution of a QBA distribution before the due date of the tax return for the year of the distribution, he has a duty to report and pay any tax due on the QBA distribution for that year.[66] If the taxpayer pays the tax, there is little need to strictly limit the time for a recontribution. Thus, one would expect that future regulations would allow the taxpayer to complete the rollover any time before the statute of limitations expires for the year of distribution. For a tax-free rollover, that would give the taxpayer sufficient time to seek a refund of the tax paid for the year of distribution.

The taxpayer could, of course, pay the tax due for the year of the QBA distribution and then allow the period of limitations to expire without recontributing the distribution. With the tax irrevocably paid, however, it is highly unlikely that the taxpayer could, or would then want to, try to complete the rollover to a non-Roth employer account or a traditional IRA. Attempting to complete the rollover under those circumstances could make sense only in the highly unlikely event that future regulations providentially provide that the recontribution would be a valid rollover that (1) avoided the excise tax on excess contributions and (2) gave the taxpayer after-tax investment in the recipient eligible plan to compensate for the previous, and now irrevocable, payment of tax on the distribution.

B. Recontribution Periods for Roth Entities

If the tax has been timely paid on a QBA distribution, there is a good chance that future regulations could allow a Roth conversion to a Roth IRA or to a designated Roth account even though the statute of limitations has run. That is, payment of the tax on the QBA distribution is consistent with the normal requirements for a Roth conversion, regardless of the statute of limitations.[67] With the statute of limitations not a consideration, the regulations would merely be conforming to the JCT's directive to allow a QBA rollover "at any time after the distribution."[68]

In that case, the alternative of making a tax-free rollover of the QBA distribution to a traditional IRA or a non-Roth employer account would be largely irrelevant. With the tax already irrevocably paid because of the expiration of the statute of limitations, contributing the funds to a Roth IRA or a designated Roth account (potentially allowing future tax-free distributions) would always be more favorable than trying to deal with the problems associated with a contribution of the funds to a traditional IRA or a non-Roth employer account.[69]

QBA distributions that are nontaxable "qualified distributions" from Roth IRAs or designated Roth accounts might also receive the most favorable recontribution treatment under future regulations. There would not appear to be any reason to put a limit on the period during which the recipient of a nontaxable QBA distribution may recontribute it since the nontaxability of the distribution renders the statute of limitations an irrelevant consideration.[70] Note that a qualified distribution from a Roth IRA can be recontributed only to a Roth IRA.[71] A qualified distribution from a designated Roth account that is a QBA distribution can, however,

[65] Such a rule would be analogous to the treatment of rollovers of some plan loan offsets for the terminations of plans or severance of employment. The taxpayer may roll over the loan offset any time before the extended due date of the tax return for the tax year of the offset. Section 402(c)(3)(C); reg. section 1.402(c)-3; TCJA section 13613.

[66] Notice 2020-68, Q&A D-4.

[67] Section 408A(d)(3)(A)(i).

[68] JCT, *supra* note 44, at 46.

[69] In an indirect rollover to a designated Roth account, a taxpayer may roll over only the earnings portion of a distribution, and not the investment portion. The investment portion may be rolled over only in a direct trustee-to-trustee rollover to a designated Roth account. Fortunately, the code provides that a QBA distribution "shall be treated" as having been recontributed (rolled over) in a direct trustee-to-trustee transfer. Section 72(t)(2)(H)(v)(III) and (IV).

[70] Notice 2020-68, Q&A D-4.

[71] Section 408A(d)(1), (d)(2), and (e)(1)(A).

be recontributed to a designated Roth account or to a Roth IRA.[72]

V. Plans That Do Not Permit QBA Distributions

The IRS has announced that, even if an eligible plan does *not* permit QBA distributions, a participant receiving some other type of permitted distribution may be able to convert it in effect to a QBA distribution — that is, a participant who receives some other type of "in-service" distribution that also happens to meet the definition of a QBA distribution may treat the distribution as a QBA distribution (even though the plan does not). The recharacterized in-service distribution, while includible in gross income, is not subject to the early distribution penalty.[73] Further, the participant may thereafter roll over the recharacterized distribution tax free to an IRA using the extended rollover period for QBA distributions.[74]

Eligible plans may allow various types of in-service distributions that a participant may convert to QBA distributions. Generally, the regulations provide that a profit-sharing or stock bonus plan may permit commencement of distributions "after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment."[75] Although distributions triggered by retirement, death, or severance of employment are not in-service distributions, distributions permitted after a fixed number of years or upon the attainment of a stated age may be in-service distributions that a qualifying participant can convert to QBA distributions. A fixed number of years means two or more years after the contribution or five or more years after first participation.[76]

A. Elective Contribution Funds

Unfortunately, it is generally more difficult for a participant to recharacterize in-service distributions of elective contributions as QBA distributions. The same is true of in-service distributions of qualified matching contributions or qualified nonelective contributions (referred to hereafter as contributions similar to elective contributions).[77] For this purpose, plans allowed to accumulate elective or similar contributions are 401(k) plans, 403(b) plans, or 457 government plans, with cash or deferred features.[78] The code and regulations specify that those plans may generally permit the commencement of distributions attributable to elective or similar contributions no earlier than the occurrence of one of the following events:

1. the participant's severance from employment;[79]
2. the calendar year in which the participant reaches age 59½;[80]
3. the disability of the participant (but not for a 457 government plan);[81]
4. the death of the participant;[82]
5. the hardship of the participant (but an unforeseeable emergency for a 457 government plan);[83]

[72] Section 402A(c)(3)(A) and (d)(1); reg. section 1.402A-1, Q&A 5.

[73] Notice 2020-68, Q&A D-18. Note that if a QBA distribution were a "qualified distribution" from a designated Roth account, the distribution would not be taxable. Section 402A(d)(1).

[74] *Id*. Section 72(t)(2)(H)(v)(III).

[75] Reg. section 1.401-1(b)(ii) and (iii); The IRS has expressly extended this rule to some funds in section 403(b) plans. Reg. section 1.403(b)-6(b).

[76] Rev. Rul. 71-295, 1971-2 C.B. 184; Rev. Rul. 68-24, 1968-1 C.B. 150.

[77] Accumulated contributions that have distribution commencement constraints like the constraints on elective contributions include qualified matching contributions (QMACs) and qualified nonelective contributions (QNECs). QMACs are employer contributions that match a participant's elective contributions; those matching contributions must satisfy the same distribution commencement constraints that apply to elective contributions. QNECs are employer contributions, other than elective contributions or QMACs, that also satisfy the distribution commencement constraints applicable to elective contributions. Section 401(k)(3)(D)(ii). *See also* the definitions of QNEC and QMAC at reg. section 1.401(k)-6.

[78] Sections 401(k)(2)(A) and 403(b)(1)(E); reg. sections 1.401(k)-1(f)(1) and 1.457-4.

[79] Sections 401(k)(2)(B)(i)(I), 403(b)(11)(A) and (7)(A)(i)(III), and 457(d)(1)(A)(ii).

[80] Sections 401(k)(2)(B)(i)(III) and (7)(C), 403(b)(11)(A) and (7)(A)(i)(II), and 457(d)(1)(A)(i). Commencement at age 59½ does not apply to 401(k) plans that are pre-ERISA money purchase plans. Section 401(k)(6).

[81] Sections 401(k)(2)(B)(i)(I), 403(b)(11)(A) and (7)(A)(i)(IV).

[82] Sections 401(k)(2)(B)(i)(I), 403(b)(11)(A) and (7)(A)(i)(I); reg. section 1.457-6(b).

[83] Sections 401(k)(2)(B)(i)(IV) and (7)(C), 403(b)(11)(B), and 457(d)(1)(A)(iii). Commencement upon hardship is not allowed for 401(k) plans that are pre-ERISA money purchase plans. Section 401(k)(6). Nor are hardship distributions allowed for funds in a 403(b) custodial account that are not attributable to elective contributions. Section 403(b)(7)(A)(i)(V).

6. service in the uniformed services for more than 30 days;[84]
7. active duty as a military reservist (but not for a 457 government plan);[85]
8. the existence of pre-1989 assets held in a section 403(b) plan;[86] or
9. termination of the plan.[87]

Unfortunately, distributions attributable to elective or similar contributions that are made after retirement, death, disability, or other severance from employment are not in-service distributions and thus cannot be recharacterized as QBA distributions. Further, a distribution upon commencing service in the uniformed services is not an in-service distribution for a participant who is not a military reservist.[88] On the other hand, a plan may provide for in-service distributions of elective or similar contributions (that a participant may be able to convert to QBA distributions) when the participant (1) reaches age 59½, (2) experiences a hardship or unforeseeable emergency, (3) commences active duty as a military reservist, (4) benefits from the existence of pre-1989 assets held by a section 403(b) plan, or (5) has an interest in a terminating plan. Unfortunately, as explained below, some of the benefits of converting these in-service distributions to QBA distributions are problematic.

1. Participant over age 59½.

As noted, if a participant over 59½ receives an in-service distribution attributable to elective or similar contributions from a plan that does not allow QBA distributions, the participant may nevertheless treat the distribution as a QBA distribution if it otherwise qualifies.[89] In reality, however, few children are born to, or adopted by, parents over 59½ (or parents over 58½, to take into account the one-year distribution period after a birth or adoption). Thus, few participants will qualify for a recharacterizable in-service distribution under the age 59½ commencement rule.

2. Hardship or unforeseeable emergency.

Surprisingly, a participant's recharacterization of an in-service distribution for hardship or unforeseeable emergency to a QBA distribution may convert the distribution from one that is not eligible for rollover to one that is eligible for rollover.[90] Thus, the participant not only avoids the early distribution penalty[91] but also may thereafter recontribute the recharacterized distribution to an IRA using the extended rollover period available for QBA distributions. The IRS states that the participant "may treat the distribution" as a QBA distribution on her tax return and "may recontribute the amount to an IRA," apparently without regard to the distribution's original status as a distribution ineligible for rollover.[92]

[84] Sections 414(u)(12)(B)(i), 401(k)(2)(B)(i)(I), 403(b)(11)(A) and (7)(A)(i)(III), and 457(d)(1)(A)(ii); Notice 2010-15, 2010-6 IRB 390. Uniformed services include the Armed Forces, the Army National Guard, the Air National Guard, and other miscellaneous services. *Id.*; section 3401(h)(2)(A); 38 U.S.C. 4303(16).

[85] Sections 401(k)(2)(B)(i)(V), 403(b)(11)(C) and (7)(A)(i). A severance from employment that will allow commencement of distributions occurs under a 401(k) plan or a 403(b) plan when a participant who is a military reservist reports to active duty. The plan may make a distribution of elective deferrals to the participant if the period of active duty is at least 179 days or an indefinite period. The participant will not incur the penalty for early distribution. 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. If a distribution satisfies both the reservist rule and the 30-day uniformed services rule, the reservist rule controls to the extent that there is any conflict. Notice 2010-15.

[86] Section 1123(c) and (e)(2) of TRA 1986 and section 1011A(c)(11) of the Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647).

[87] Section 401(k)(2)(B)(i)(II); reg. sections 1.403(b)-10(a) and 1.457-10(a). Upon termination of a 403(b) plan containing interests in 403(b)(7) custodial accounts, the plan may generally distribute individual custodial accounts (ICAs) tax free if specific conditions are met. In that case, the ICAs may continue to be treated as if they were 403(b) plans, and funds in the ICAs are not taxed until distributed. Rev. Rul. 2020-23, 47 IRB, sets forth the rules for the distribution of ICAs by plans not required to provide spousal annuities under section 205 of the Employee Retirement Income Security Act of 1974 (P.L. 93-406). The IRS is, however, having difficulty reconciling spousal annuity requirements with the distribution of ICAs and has asked for comments from practitioners regarding the problem. Notice 2020-80, 47 IRB 1028.

[88] Notice 2010-15, Q&A 11.

[89] Notice 2020-68, Q&A D-18.

[90] Section 402(c)(4)(C). Because 457 government plans do not provide for hardship distributions but may allow distributions for unforeseeable emergencies, the question arises whether rollovers of distributions from 457 government plans for unforeseeable emergencies are forbidden. The IRS has indicated that the answer is yes. The IRS has also indicated that distributions from other plans for rollovers to a 457 government plan will not qualify as eligible rollover distributions if they are distributions for either unforeseeable emergencies or hardships. Rev. Proc. 2004-56, 2004-2 C.B. 376.

[91] *Milner v. Commissioner*, T.C. Memo. 2004-111; *Robertson v. Commissioner*, T.C. Memo. 2000-100; similarly, *Adams v. Commissioner*, T.C. Memo. 2015-162; *Cheves v. Commissioner*, T.C. Memo. 2017-22.

[92] Notice 2020-68, Q&A D-18.

3. Active service as a military reservist.

As noted above, a distribution upon the commencement of active service in the uniformed services is generally not an in-service distribution.[93] A distribution upon the commencement of active duty as a military reservist may, however, be an in-service distribution if all requirements are met.[94] Thus, a participant may be able to convert a military reservist contribution into a QBA distribution. Further, if a distribution qualifies as both an active uniformed service distribution and a military reservist distribution, it will be treated as a military reservist distribution eligible for recharacterization as a QBA distribution.[95]

A participant who cannot or does not convert a reservist distribution to a QBA may still recontribute the reservist distribution to an IRA at any time before the period ending two years after the completion of active duty. The recontribution is, however, not a tax-free rollover. The original distribution remains taxable.[96] On the other hand, if the distribution is instead converted to a QBA distribution, the statute provides no specific time limit on recontribution (although, as discussed above, the IRS is expected to do so by regulation).[97] More importantly, the recontribution to a traditional IRA of a reservist distribution that is recharacterized as a QBA distribution is a tax-free rollover.[98] Thus the tax paid on the distribution is refundable if the statute of limitations has not run.

4. Pre-1989 assets of a 403(b) plan.

If a participant receives in-service distributions of pre-1989 assets held by a 403(b) plan, he may treat the distributions as QBA distributions if he meets QBA requirements. In this connection, note that in-service distributions of pre-1989 assets are allowed without limit from 403(b) annuity contracts and 403(b) retirement income accounts. However, for 403(b) plans that are custodial accounts, in-service distributions of the pre-1989 assets are allowed without limit only for qualifying hardship distributions.[99]

Unfortunately, a participant is unlikely to have pre-1989 assets in his separate 403(b) account unless he was employed before 1989. Thus, distribution of those assets and their recharacterization will generally be available only to older participants, who are, of course, much less likely to give birth to children or adopt them.

5. IRA distributions.

It is unclear whether the IRS intended to allow the conversion of an IRA distribution to a QBA distribution when the IRA does not expressly permit QBA distributions. The IRS states that such a recharacterization is allowable for eligible plans, a term that includes IRAs. On the other hand, the IRS limits those recharacterizations to *in-service* distributions, a term that is meaningless when applied to an IRA.[100] In any event, this uncertainty can be easily avoided by simply transferring the IRA funds to an IRA that allows QBA distributions.

VI. Conclusion

The QBA exception to the early distribution penalty is a welcome addition to the other long-standing exceptions to the penalty. The value of the QBA exception is further enhanced by the right to eventually recontribute the QBA distribution to an eligible plan in a transaction treated as a rollover.

Although future regulations are expected to place some limits on the rollover period, the period will certainly be far more generous than the 60-day period normally allowed for an indirect rollover.

[93] Notice 2010-15, Q&A 11.

[94] Notice 2010-15, Part IV.

[95] Notice 2010-15, Q&A 15.

[96] Section 72(t)(2)(G)(ii).

[97] Section 72(t)(2)(H)(iv)(III); Notice 2010-15.

[98] Section 72(t)(2)(H)(iv)(III).

[99] Section 1123(c) and (e)(2) of the Tax Reform Act of 1986 (P.L. 99-514) and section 1011A(c)(11) of TAMRA. Section 403(b) plans are of three general types. The first type consists of commercially purchased annuities. Section 403(b)(1). The second type is a custodial account that may invest only in regulated mutual funds (referred to hereafter in this article simply as a "custodial account"). Section 403(b)(7); reg. section 1.403(b)-8(d). The third type is a "retirement income account," a type of individual account plan that only churches and their related organizations may establish. Retirement income accounts need not limit their investments to purchased annuities or mutual funds and may be established for self-employed ministers. Section 403(b)(9); reg. section 1.403(b)-9; preamble to T.D. 9142, section E.

[100] Notice 2020-68, Q&A D-18.

If, however, a taxpayer fails to include a taxable QBA distribution in gross income for the year of the distribution, the regulations are likely to provide that a recontribution of the distribution may be made no later than the extended due date of the tax return for the tax year of the distribution.

On the other hand, if the taxpayer properly includes the distribution in gross income for the year of the distribution, the regulations are likely to provide that a recontribution of a QBA distribution may be made any time before the expiration of the period of limitations for the year of distribution. For Roth conversions and qualified Roth distributions, the rules may be even more lenient. There can be, however, no guarantees regarding the actual reach of future regulations.

A qualifying participant in an employer plan that does not permit QBA distributions may be able to recharacterize another type of in-service distribution as a QBA distribution. Unfortunately, for distributions of funds attributable to elective and similar contributions, such a conversion may have limited utility because allowable in-service distributions of those funds are generally skewed toward older plan participants who are past normal child-bearing age. ■