



It “(t)” Time—Exceptions to the Early Distribution Penalty under §72(t)



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## **Distributions from Retirement Accounts**

Two recent cases help illustrate some of the complexities and traps involved in the early distribution addition to tax under §72(t) for distributions from qualified retirement plans and individual retirement accounts. The cases we will look at include the taxpayer loss in *Domanico v. Commissioner*, TC Summary 2006-55 and the taxpayer win in *Rideaux v. Commissioner*, TC Summary 2006-74.

Congress designed the law for tax deferred retirement account to generally discourage taxpayers from taking early distributions from their retirement accounts by imposing a special 10% addition to tax (often incorrectly referred to as a penalty—it actually isn't phrased as such) for taxpayers who took their distributions “too early” from their retirement plans, generally before age 59½. However, under certain fact patterns the 10% distribution doesn't apply to some or all of the distribution.

Many, but not all, of the exceptions are the same for distributions from qualified retirement plans as for individual retirement accounts. However, in the case of *Domanico* confusion over this matter, along with over broadly interpreting a clause in the *CCH United States Master Tax Guide*, exposed the taxpayer to a penalty she wasn't expecting.

For some exceptions, determining the taxpayer's qualification for the exception is fairly easy—but for others its not so clear, even when all parties agree on the facts and that they have been properly documented. That was the case in *Rideaux* where the question became whether the taxpayer met the definition of disabled as given for §72.

## The Exceptions

The 10% addition to tax itself is found in §72(t)(1):

**72(t)(1) IMPOSITION OF ADDITIONAL TAX. --**

If any taxpayer receives any amount from a qualified retirement plan (as defined in section 4974(c)), the taxpayer's tax under this chapter for the taxable year in which such amount is received shall be increased by an amount equal to 10 percent of the portion of such amount which is includible in gross income.

Note that the default is that it applies to all distributions from retirement plans. As we've noted before, this is a rather standard construct you find in the tax law where a very broad general rule is given, and then a list of “exceptions” are added. When that happens, you have to apply the general rule unless you find a specific exception listed.

The “first shot” list of exceptions are found at §72(t)(2).

**72(t)(2) SUBSECTION NOT TO APPLY TO CERTAIN DISTRIBUTIONS. --**

Except as provided in paragraphs (3) and (4), paragraph (1) shall not apply to any of the following distributions:

**72(t)(2)(A) IN GENERAL. --Distributions which are --**

**72(t)(2)(A)(i)** made on or after the date on which the employee attains age 59½,

**72(t)(2)(A)(ii)** made to a beneficiary (or to the estate of the employee) on or after the death of the employee,

**72(t)(2)(A)(iii)** attributable to the employee's being disabled within the meaning of subsection (m)(7),

**72(t)(2)(A)(iv)** part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee

or the joint lives (or joint life expectancies) of such employee and his designated beneficiary,

**72(t)(2)(A)(v)** made to an employee after separation from service after attainment of age 55,

**72(t)(2)(A)(vi)** dividends paid with respect to stock of a corporation which are described in section 404(k), or

**72(t)(2)(A)(vii)** made on account of a levy under section 6331 on the qualified retirement plan.

**72(t)(2)(B) MEDICAL EXPENSES. --**

Distributions made to the employee (other than distributions described in subparagraph (A), (C) or (D)) to the extent such distributions do not exceed the amount allowable as a deduction under section 213 to the employee for amounts paid during the taxable year for medical care (determined without regard to whether the employee itemizes deductions for such taxable year).

**72(t)(2)(C) PAYMENTS TO ALTERNATE PAYEES PURSUANT TO QUALIFIED DOMESTIC RELATIONS ORDERS. --**

Any distribution to an alternate payee pursuant to a qualified domestic relations order (within the meaning of section 414(p)(1)).

**72(t)(2)(D) DISTRIBUTIONS TO UNEMPLOYED INDIVIDUALS FOR HEALTH INSURANCE PREMIUMS. --**

**72(t)(2)(D)(i) IN GENERAL.** --Distributions from an individual retirement plan to an individual after separation from employment --

**72(t)(2)(D)(i)(I)** if such individual has received unemployment compensation for 12 consecutive weeks under any Federal or State unemployment compensation law by reason of such separation,

**72(t)(2)(D)(i)(II)** if such distributions are made during any taxable year during which such unemployment compensation is paid or the succeeding taxable year, and

**72(t)(2)(D)(i)(III)** to the extent such distributions do not exceed the amount paid during the taxable year for insurance described in section 213(d)(1)(D) with respect to the individual and the individual's spouse and dependents (as defined in section 152, determined without regard to subsections (b)(1), (b)(2), and (d)(1)(B) thereof).

**72(t)(2)(D)(ii) DISTRIBUTIONS AFTER REEMPLOYMENT.** --Clause (i) shall not apply to any distribution made after the individual has been employed for at least 60 days after the separation from employment to which clause (i) applies.

**72(t)(2)(D)(iii) SELF-EMPLOYED INDIVIDUALS.** --To the extent provided in regulations, a self-employed individual shall be treated as meeting the requirements of clause (i)(I) if, under Federal or State law, the individual would have received unemployment compensation but for the fact the individual was self-employed.

**72(t)(2)(E) DISTRIBUTIONS FROM INDIVIDUAL RETIREMENT PLANS FOR HIGHER EDUCATION EXPENSES.** --

Distributions to an individual from an individual retirement plan to the extent such distributions do not exceed the qualified higher education expenses (as defined in paragraph (7)) of the taxpayer for the taxable year. Distributions shall not be taken into account under the preceding sentence if such distributions are described in subparagraph (A), (C), or (D) or to the extent paragraph (1) does not apply to such distributions by reason of subparagraph (B).

**72(t)(2)(F) DISTRIBUTIONS FROM CERTAIN PLANS FOR FIRST HOME PURCHASES.** --

Distributions to an individual from an individual retirement plan which are qualified first-time homebuyer distributions (as defined in paragraph (8)). Distributions shall not be taken into account under the preceding sentence if such distributions are described in subparagraph (A), (C), (D), or (E) or to the extent paragraph (1) does not apply to such distributions by reason of subparagraph (B).

You need to immediately note that the last three exceptions are specifically limited to distributions from individual retirement accounts—that is, those for health insurance during periods of unemployment, higher education expenses and “first home” purchases.

In these matters, taxpayers “foul it up” by not first rolling over any distribution from the plan to an IRA account and then taking the distribution from the IRA account itself. While we can all wonder about the absurdity of a provision that imposes a bad result on taxpayers who don’t execute a flurry of paperwork, nevertheless the courts have held that given the clarity of the law, that’s what Congress intended and any fix has to come from there.

At first glance, you might conclude all of the other exceptions “work” for IRA accounts. But you would be wrong, as Congress put down in (3) the IRA “gotcha” provisions.

If you keep reading, you come across this additional caveat at §72(t)(3)(A):

**72(t)(3)(A) CERTAIN EXCEPTIONS NOT TO APPLY TO INDIVIDUAL RETIREMENT PLANS.** --Subparagraphs (A)(v) and (C) of paragraph (2) shall not apply to distributions from an individual retirement plan.

The items in question are separation from service after attainment of age 55 (§72(t)(2)(A)(v)) and QDRO payments (§72(t)(2)(C)). In neither of those cases would a distribution from an IRA be eligible for a waiver of the 10% penalty.

In this case, taxpayers who roll over a distribution from a plan that would have qualified for the exception are now the ones who get clobbered by an absurd provision.

## Education Expenses and the Qualified Plan

In *Domanico*, we find the case of a taxpayer who was trapped by the fact that education expenses are not one of the exceptions allowed for distributions from a qualified plan, though they do count for distributions from an IRA.

Linda Domanico had previously been employed by TWA as a flight attendant. She suffered an injury that prevented her from continuing work as a flight attendant and went back to graduate school, being employed later as a librarian.

In 2001, Linda received a letter from TWA indicating that due to its acquisition by American Airlines, she was eligible to receive a distribution of her account balance in the TWA 401(k) plan. Linda took the distribution and used it pay both her current year education expenses as well as prior year expenses and those for future years. Based on those payments she treated none of the distribution as subject to the 10% penalty.

The court summarized the process Linda used to decide this was the proper treatment:

Petitioners contend that the distribution from Mrs. Domanico's 401(k) plan is excepted from the 10-percent additional tax on early distributions because they used the funds to pay for Mrs. Domanico's higher education expenses incurred from 1999 through 2003. In support of their contention, petitioners rely on paragraph 2179 of the Master Tax Guide that states in pertinent part:

2179. Early Distributions. Distributions from a traditional IRA to a participant before the individual has reached age 59 1/2 are generally subject to the same 10% penalty that applies to early distributions from qualified plans. Many of the exceptions to the early distribution penalty also apply to early distributions from a traditional IRA. \* \* \* The following exceptions to the 10% penalty also apply when early distributions are made from an IRA.

\* \* \* \* \*

*Education Expenses.* The 10% penalty does not apply if the individual uses the IRA money to pay for "qualified higher education expenses" for the individual, the individual's spouse, child, or grandchild of the individual or the individual's spouse. Qualified expenses included [sic] tuition at a post-secondary educational institution, books, fees, supplies and equipment (Code Sec. 72(t)(2)(E)). [Emphasis added.]

Therefore, in petitioners' view, because distributions from an IRA and a qualified plan; i.e., a 401(k) plan, are treated the same in some instances for purposes of the 10-percent penalty and because a distribution from an IRA that is used for higher education expenses is exempt from the 10-percent penalty, a distribution from a qualified plan that is used for higher education expenses should also be exempt from the 10-percent penalty. Moreover, according to petitioners, a one-time distribution should cover expenses incurred over a number of years because paragraph 2179 of the Master Tax Guide does not state that the funds must be used in the same calendar year that the distribution is received. As discussed below, we disagree with petitioners' contention.

The court first notes that reliance on the *Master Tax Guide* is not adequate to carry the issue on this matter:

First, it is well settled that the authoritative sources of Federal tax law are the statutes, regulations, and judicial decisions and not guides such as the Master Tax Guide that are published by private commercial publishers. See, e.g., *Zimmerman v. Commissioner*, 71 T.C. 367, 371 (1978), affd. without published opinion 614 F.2d 1294 (2d Cir. 1979).

The court next goes on to note what the law does say that is relevant to the matter:

Lastly, as relevant herein, the 10-percent additional tax imposed on early distributions from qualified retirement plans does not apply to distributions from "individual retirement plans" used for higher education expenses of the taxpayer for the taxable year. Sec. 72(t)(2)(E). An individual retirement plan is defined as an individual retirement account or individual retirement annuity (commonly referred to as IRAs). Sec. 7701(a)(37). Retirement plans qualified under section 401(a) and (k), however, are not included in the definition of "individual retirement plan" under section 7701(a)(37).

The Court then notes that based on the law:

Clearly, Congress intended this exception to apply only to distributions from "individual retirement plans"; i.e., IRAs, and not to all qualified retirement plans.

Finally, the Court includes a commentary that indicates it understands how the taxpayers were caught by this provision and how it feels the Tax Court has no ability, on its own, to resolve this problem:

In closing, we think it appropriate to observe that we found petitioners to be very conscientious taxpayers who obviously take their Federal tax responsibilities quite seriously. We recognize that the difference between a qualified retirement plan and an IRA is highly technical, and we applaud petitioners for their efforts in researching the tax consequences of receiving a

401(k) plan distribution. The Tax Court, however, is a court of limited jurisdiction and lacks general equitable powers. *Commissioner v. McCoy*, 484 U.S. 3, 7 (1987); *Hays Corp. v. Commissioner*, 40 T.C. 436, 442-443 (1963), affd. 331 F.2d 422 (7th Cir. 1964). Consequently, our jurisdiction to grant equitable relief is limited. *Woods v. Commissioner*, 92 T.C. 776, 784-787 (1989); *Estate of Rosenberg v. Commissioner*, 73 T.C. 1014, 1017-1018 (1980). Although we acknowledge that petitioners used the 401(k) plan distribution for a laudable purpose, absent some constitutional defect, we are constrained to apply the law as written, see *Estate of Cowser v. Commissioner*, 736 F.2d 1168, 1171-1174 (7th Cir. 1984), affg. 80 T.C. 783, 787-788 (1983), and we may not rewrite the law because we may "'deem its effects susceptible of improvement'", *Commissioner v. Lundy*, 516 U.S. 235, 252 (1996) (quoting *Badaracco v. Commissioner*, 464 U.S. 386, 398 (1984)). Accordingly, petitioners appeal for relief must, in this instance, be addressed to their elected representatives. "The proper place for a consideration of petitioner's complaint is the halls of Congress, not here." *Hays Corp. v. Commissioner*, supra at 443.

Clearly, had the taxpayer merely rolled the distribution to an IRA first, she could have eliminated the penalty on the current year's education expense payments. Note that, as pointed out in *Lodder-Beckert v. Commissioner*, TC Memo 2005-162 last July, it still would not have solve the other years problems (Lodder-Beckert had transferred her distribution to an IRA, but she used it to pay off debt).

## What Constitutes Disability?

Although the taxpayer in Domanico lost her case, the IRS did not fare as well in another *pro se* case in the Tax Court. In the case of *Rideaux v. Commissioner*, TC Summary 2006-74, the issue turned on whether the taxpayer qualified for the exception from the penalty per §72(t)(2)(A)(iii). In turn, that issue turns on the definition of disabled found in §72(m)(7). That definition reads:

### **72(m)(7) MEANING OF DISABLED. --**

For purposes of this section, an individual shall be considered to be disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration. An individual shall not be considered to be disabled unless he furnishes proof of the existence thereof in such form and manner as the Secretary may require.

Mr. Rideaux was employed as a boiler mechanic for 20 years for Southern Cal Edison. The court described Mr. Rideaux's job as follows:

As a boiler mechanic, petitioner's job was to maintain power generating stations, which required him to engage in "heavy work". When working on a

boiler, petitioner was required to lift large pieces of metal with his coworkers that weighed between 250-300 pounds. Petitioner's responsibilities included, among other things, replacing valves, doing boiler overhauls, welding on a steel platform on his knees, and constructing parts for maintenance of the power plant.

Mr. Rideaux sustained a number of injuries related to his job that were listed by the Tax Court:

Petitioner has a history of physical injuries sustained while working for Southern Cal. In 1987, petitioner had surgery for his back. In 1989, petitioner started to notice pain in his left shoulder while performing his regular job duties. The physician diagnosed him with bursitis (shoulder tendonitis) which was likely a result of repetitive use of his left upper extremity, required while lifting, pushing, and pulling heavy materials, including pumps, valves, flat plates, and other parts of the boilers. Since that time, petitioner has been self-treating with medications as well as applications of heat and ice. In 2003, petitioner received an injection of steroids for his left shoulder to ease the pain.

In February of 2001, petitioner sustained a work-related injury to his left knee. Petitioner had knee surgery, took a leave of absence, and has not worked since his knee injury in 2001. Although petitioner has a full range of motion for his left knee, he suffers pain to his knee with movement and weight bearing.

As a result of his knee injury in 2001, petitioner started having complications with his back, and he received a series of epidural steroid injections to ease the pain to his lumbar spine.

In 2003, petitioner was diagnosed with arthritis in the left knee, lumbar radiculopathy (pain in the lower extremities), epidural fibrosis of the lumbar spine (scar tissue near the nerve spot), obesity, and a left shoulder rotator cuff tear. Some of these physical ailments stemmed from or are related to injuries that petitioner sustained in earlier years.

The taxpayer attempted to improve his condition via steps the Court outlined:

Due to his knee injury, petitioner gained 40 pounds from inactivity. His weight exacerbated his knee and back pain, which hampered his recovery. Petitioner's physicians recommended that he participate in a weight loss program as part of his treatment. During 2003, petitioner went to physical therapy three times a week and was required to engage in a home exercise program. Petitioner was asked to limit his weight bearing, lifting, and bending activities. In addition, petitioner went for an orthopedic reevaluation approximately every 6 weeks to track the progress of his recovery.

By letter dated January 20, 2006, petitioner's primary treating physician, Dr. Steven Nagelberg, advised that he had been treating petitioner for work-related

injuries from March 14, 2002, to December 10, 2005, for a left rotator cuff tear, left knee arthritis, and lumbar radiculopathy. Dr. Nagelberg further advised that petitioner was considered "temporarily totally disabled" from March 14, 2002, to December 10, 2005.

While on leave due to his injuries Mr. Rideaux was offered, and accepted, an early retirement package from his employer. Mr. Rideaux was 50 years old at the time he received this distribution.

The taxpayer reported the distribution as follows:

Petitioner filed a Form 1040, U.S. Individual Income Tax Return, for 2003, on which he included the distribution as income. Petitioner claimed on line 2 of Form 5329, Additional Taxes on Qualified Plans (including IRAs) and Other Tax-Favored Accounts, that he was excepted from the additional tax on early distributions, because the distribution was due to total and permanent disability.

The IRS examined Mr. Rideaux's return and determined he did not meet the definition of disabled, thus was not eligible for relief from the 10% addition to tax.

The Tax Court noted that the issue turned on the definitions found in §72(m)(7) and Regulation §1.72-17(f). The Court summarized these requirements as follows:

The determination of whether a taxpayer is disabled is made with reference to all the facts of the case. See sec. 1.72-17A(f)(2), Income Tax Regs. The regulations also set forth general considerations upon which a determination of disability is to be made, such as the nature and severity of the impairment. See sec. 1.72-17A(f)(1), Income Tax Regs.

The regulations emphasize that the "substantial gainful activity" to which section 72(m)(7) refers is the activity, or a comparable activity, in which the individual customarily engaged prior to the arising of the disability. See *Dwyer v. Commissioner*, supra at 341; sec. 1.72-17A(f)(1), Income Tax Regs. Therefore, the impairment must be evaluated in terms of whether it does, in fact, prevent the individual from engaging in his customary, or any comparable, substantial gainful activity considering the individual's education, training, and work experience. Sec. 1.72-17A(f)(1), Income Tax Regs.

The IRS placed emphasis on the fact that the 1099R for Mr. Rideaux from the plan indicated that this was a "premature distribution, no known exception" to show that Mr. Rideaux did not qualify. The Court notes this point, but then goes to ignore the matter—as it should. Just as the *Master Tax Guide* does not create tax law, as the IRS noted in the first case we looked at, the employee benefits administration employee that fills in a 1099R does not carry weight when compared to the facts of the situation.

The Court then looks at the real issue—was Mr. Rideaux disabled in the fashion the law requires to avoid the 10% addition. The Court notes:

According to the medical evaluations from petitioner's physicians during 2003, petitioner experienced pain whenever he moved or shifted weight onto his left knee. As a result, petitioner was unable to return to work, because he could not lift heavy objects. Even had petitioner not retired, the evidence shows that petitioner's injuries were such that he could no longer perform his job. See *Brown v. Commissioner*, T.C. Memo. 1996-421 (finding that petitioner was "disabled" since he could not climb ladders, or otherwise lift heavy objects, or "walk beams", because his position as a project engineer required him to be substantially mobile and physically fit).

But, as noted, if the injury is such that it is not “indefinite” then the exception still will not apply. So we have to look at whether these injuries meet the indefinite condition. The Court first outlines the requirements for this test as outlined in the Regulations:

The term "indefinite" under section 72(m)(7) means that it cannot reasonably be anticipated that the impairment will, in the foreseeable future, be so diminished as no longer to prevent substantial gainful activity. Sec. 1.72-17A(f)(3), Income Tax Regs. For example, an individual who suffers a bone fracture which prevents him from working for an extended period of time will not be considered disabled if his recovery can be expected in the foreseeable future; if the fracture persistently fails to knit, the individual would ordinarily be considered disabled. *Id.*

An impairment which is remediable does not constitute a disability. Sec. 1.72-17A(f)(4), Income Tax Regs. An individual will not be deemed disabled if, with reasonable effort and safety to himself, the impairment can be diminished to the extent that the individual will not be prevented by the impairment from engaging in his customary or any comparable substantial gainful activity. *Id.*

Applying Mr. Rideaux's facts to this test, the Court in the end concluded that the injury was of the “indefinite” sort. After all, his physician had labeled him as “temporarily disabled” in the letter presented in Court—was that fatal to his claim?

The Court decided it was not by reasoning from the use of the term “temporary” for the away from home expense deductions under §162(a)(2).

An employment is for an indefinite duration if its termination is not foreseeable or is not reasonably expected to be foreseen within a fixed or reasonably short period of time. *Mitchell v. Commissioner*, 74 T.C. 578, 581-582 (1980); *Stricker v. Commissioner*, supra at 361; *White v. Commissioner*, T.C. Memo. 1984-128; *Duley v. Commissioner*, T.C. Memo. 1979-262.

The mere labeling or designation of a job as "temporary" is not determinative; the duration of a job is indefinite if termination is not foreseeable within a short period of time. *Garlock v. Commissioner*, 34 T.C. 611 (1960); *Allison v. Commissioner*, T.C. Memo. 1986-346. Moreover, employment that was

temporary in its inception may become indefinite due to change in circumstances, or simply by the passage of time. See *Mitchell v. Commissioner*, supra at 581; *Norwood v. Commissioner*, 66 T.C. 467, 469-470 (1976); *Kroll v. Commissioner*, 49 T.C. 557, 562 (1968); *Moxey v. Commissioner*, T.C. Memo. 1988-156.

The Court applied this rationale to Mr. Rideaux's case as follows:

Similarly, although petitioner's injuries were labeled as "temporary", there was no reasonable indication, nor could it be reasonably anticipated or be foreseen at the time of the distribution in 2003, when or if petitioner would be able to return to work. Even if petitioner's injuries were "temporary" initially, over time, they became indefinite. The inability to predict when petitioner would be able to return to work, if ever, caused the disability to be indefinite within the meaning of section 72(m)(7) and section 1.72-17A(f)(3), Income Tax Regs. See *Brown v. Commissioner*, supra.

A couple of observations and caveats are in order. First, the case does illustrate that it's important to move beyond codes on Forms 1099 and the like in analyzing how the tax law applies to a taxpayer—the actual facts of what happen govern, for better or worse, and not just what's reported on a 1099. Reality is that if you disagree with the treatment a 1099 suggests and it's in the taxpayer's favor you will likely have to deal with letters from the IRS—but that doesn't change the fact that the *law* applies regardless of what the payor might think.

Second, this a very fact specific case. You should be very careful in applying this case as “proof” that your taxpayer is not to the 10% additional tax. That goes double since this case is a TC Summary case that is not considered precedential in any form. But it does offer a legal analysis that can be used with your facts to support the position, and can help show an IRS agent that the case is not as clear cut as he/she might think just because they have a 1099.