Potential Traps for Early Distributions from Qualified Retirement Plans

Summary: For employees, qualified retirement plans (QRPs) are intended to be long-term investment instruments rather than a source of funds for pre-retirement financial needs. As a result, you will face significant tax consequences for taking early distributions from your qualified retirement plans. First, early distributions are included in your gross income and are subject to regular income taxes. Second, IRC §72(t)(1) assesses an additional 10 percent penalty tax on the amount of early withdrawals from qualified retirement plans that is includible in gross income.

Fortunately, Section 72(t)(2) of the Internal Revenue Code lays out several exemptions to the penalty tax, which are listed and discussed later in the article. Many of us, nonetheless, still incur the penalty tax despite asserting that we fulfilled one of the exemptions. This happens frequently because we fail to realize that some of the exemptions apply only to certain types of qualified retirement plans, or even when the distribution is from the appropriate qualified retirement plan, a penalty tax applies due to our failure to adhere to other IRC limitations. As you may already know, an additional 10 percent tax is assessed on early withdrawals from qualified retirement plans such as; 401(k), 403(b), Annuities, IRAs, SEPs, SIMPLE plans and so on, under §72(t)(1), but §72(t)(2) provides several exceptions to this penalty tax.

Frequently, we, as taxpayers do not qualify for exemptions because the early withdrawals are not from the classification of qualified retirement plans as specified within the Internal Revenue Code. In addition, we are misunderstanding the IRC meanings of higher education expenses, qualified students, first-time homebuyers, and qualified domestic relation orders (QDROs). Also, we sometimes fail to adhere to time period and dollar value limitations when attempting to qualify for the higher education or first-time homebuyer exemptions.

Following an overview of the statutory exceptions, we arrive at three highly litigated Section 72(t)(2) exemptions. Specifically, the common mistakes in attempting to use the higher education, first-time homebuyer, and qualified domestic relation order exceptions (QDRO). Other reasons not highlighted here are hardship withdrawals. There are also tax-planning techniques that can assist you in avoiding this penalty tax. These strategies include making distributions from the appropriate qualified retirement plan and ensuring that the court issues a QDRO if divorce settlement funds are to be paid from a qualified retirement plan that is not an IRA.

Exceptions to Withdrawing Money from a Retirement Account

Section 72(t)(1) of the Internal Revenue Code applies a tax equal to 10% of the amount distributed from a “qualified retirement plan.” The 10% additional tax is levied in addition to regular income taxes unless, under §72(t)(2), the distribution from the retirement plan is made:

1. After the plan participant has reached age 59½;
2. To a beneficiary or the participant’s estate after the death of the participant;
3. Because the participant has become disabled, as described under IRC §72(m)(7);
4. To an alternate payee under a qualified domestic relations order (QDRO) (cannot be from IRAs);
5. To an employee who has separated from service under an early retirement arrangement after reaching age 55 (cannot be from IRAs under IRC §72(t)(3)(A);
6. As dividends paid from an Employee Stock Ownership Plan (ESOP) as described in IRC §401(k);
7. Through an IRS levy to collect back taxes owed by the plan participant, under IRC §6331;
8. To pay medical expenses under IRC §213 for the employee, a spouse, or dependent, but only to the extent that they exceed 7.5% of adjusted gross income and paid within the taxable year;
9. As part of a series of substantially equal periodic payments (ESPPs) over the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and a designated beneficiary.
10. To pay health insurance premiums when the employee is unemployed and the distribution is exclusively from an IRA;
11. For higher education expenses and the entire amount is paid from an IRA;
12. For a qualified first-time home purchase and the entire distribution is made exclusively from an IRA; or
13. To individuals called to active duty.

While many of the issues discussed are relatively straightforward, the volume of cases indicates the need for further awareness on this misunderstood set of exceptions. Finally, we present tax-planning techniques that can help you avoid being subject to the penalty tax.

The first objective is to locate the penalty tax exceptions under Section §72(t)(2). Next, an analysis of the recent mistakes that preclude the use of three common Section 72(t)(2) exceptions. These highly litigated exceptions are:

1. Higher education expenses
2. First-time homebuyer purchase
3. Qualified domestic relations orders (QDROs)

Three Highly Litigated Exceptions

Two of the three exceptions explicitly require that the distribution come from an IRA; higher education expenses, first-time homebuyer. The qualified domestic relations orders (QDROs) are not paid out of IRA funds.

1. Higher Education Distributions. Section 72(t)(2)(E) states that distributions are not subject to the 10% additional tax when made from an IRA, and the funds are used to pay higher education expenses of the taxpayer for the taxable year. It is critical that withdrawals for higher education expense are only taken from IRAs.

In one court case, Uscinski vs. Commissioner, 89 T.C.M. 1337 (2005); T.C. Memo. 2005-124, taxpayer withdrew $161,447 from his 401(k) plan during 2000 to pay higher education expenses. Mr. Uscinski argued that he was not liable for the penalty because he used the funds to pay higher education expenses as stipulated under §72(t)(2)(E). IRS determined that the distribution was subject to the 10% additional tax because §72(t)(2)(E) expressly provides that it covers distributions to an individual from an IRA. This makes Mr. Uscinski's distribution not exempt because it was from a qualifed plan instead of an IRA. The Tax Court sided with the IRS noting that a qualified 401(k) plan does not fall within the IRA category as described under §408.

The distribution from the IRA must be used to pay higher education in the same year as the withdrawal. All of the costs incurred must be for qualified educational expenses otherwise, those costs will be considered non-qualifed distributions and subject to the additional 10% tax. Qualifed higher education expenses are defined under Section 529(e)(3) as tuition, fees, books, supplies, equipment, and room and board. The student must also be a qualifed student, as described under §25A(b)(3)(B), meaning the student must carry at least half the normal workload of a full-time student, or be enrolled in a qualified institution for at least 5 months out of a calendar year. Finally, the distribution from the IRA is still subject to regular income tax, likewise any distributions taken to pay such income tax.

2. First-Time Home Buyer Distributions. The first-time homebuyer's exemption only applies to early withdrawals taken from IRAs, and not qualifed retirement plans such as 401(k) or 403(b). According to §72(t)(8)(A), a qualifed homebuyer distribution is one that is used within 120 days of the distribution date. Moreover, the distribution must be used to pay qualified acquisition costs for a principal residence of the first-time homebuyer who is an individual, spouse of the individual, child, grandchild, or ancestor of the first-time homebuyer or the individual's spouse. The amount that can be withdrawn is limited to $10,000, as prescribed under §72(t)(8)(B).

When the funds are not available in IRA form and if the opportunity exists, the taxpayer should roll such non-IRA qualifed retirement plan funds into an IRA before making first-time homebuyer distributions.

In Jones vs, Commissioner, the taxpayer resigned from his company to pursue his PH.D in September 1999. Subsequently, in 2001, Mr. Jones withdrew $30,368 from his 401(k) plan for multiple purposes, including the purchase of his first home. Mr. Jones asserted that the distribution was not subject to the additional 10% penalty because he had the potential to roll his 401(k) over into an IRA. Furthermore, he stated that §72(t)(2)(F) should apply to the disbursements used to pay for his first home because the difference between a 401(k) and an IRA account is only a matter of form. IRS disagreed and contended that the exception was not applicable because the distribution was not from an IRA. The Tax Court expressed its sympathy with Mr. Jones because the differences between a qualifed retirement plan and an IRA are highly technical. The Court was bounded by the rules of law and sided with the IRS.

To qualify for the exemption, the early withdrawal must be used to acquire the home within 120 days of the distribution date and this is statutory language. The IRS or the Tax Court may not accept excuses as to why the purchase did not occur within this time period if you filed a petition. The statutory language of the law binds the judicial decision.

For a married couple, both individuals must meet the definition of a first-time homebuyer. Thus, if one spouse owned a residence within a 2-year period before acquiring another residence, that residence will not qualify as a first-time purchase and any distributions used to purchase the residence will not qualify for the exception. This is also true even if the spouse was never a homeowner. §72(t)(8)(D)(i)(I) defines a first-time homebuyer as an individual (and if married, the individual's spouse) who does not have ownership in a principal residence within 2 years of acquiring a new principal residence.

3. Qualified Domestic Relations Orders. §72(t)(2)(C) exempts early distributions from the 10% additional tax if those withdrawals are made as a result of a qualified domestic relations order (QDRO) as defined under §414(p)(1). A domestic relations order is a judgment that relates to providing child support, alimony, or marital property rights to a spouse, former spouse, child, or other dependent of a participant, and is made pursuant to a state domestic relations order. A QDRO also qualifies an alternate payee to receive the amount of benefits under the plan. An alternate payee is defined as any spouse, former spouse, child, or other dependent of a participant who has the right to receive all, or a portion of, the benefits payable under a plan of such participant.

The QDRO does not apply to IRAs. So, if funds are withdrawn from an IRA to pay state specified orders, the withdrawals will be subject to the 10 percent additional tax. However, the Tax Court noted that the law excludes distributions from the penalty tax if made pursuant to a QDRO within the meaning of §414(p)(1). But, at the same time, the exception does not apply to IRAs. As such, the court held that a taxpayer is liable for the additional penalty tax.

Tax Planning Opportunities

If you are considering or have already taken an early distribution from a qualified plan, you should be advised of the following in order to avoid the §72(t)(1) tax:

1. If you intend to use the distribution for higher education expenses or are a first-time homebuyer, make sure the distribution is from an IRA.
2. If you have already mistakenly taken funds from a non-IRA plan for higher education and the IRS is willing to allow any portion of the distribution to qualify as an exception, it might be advantageous for you to settle rather than take it to court.
3. You should make sure an IRA distribution taken for higher education is made in the year the expenses are paid. In addition, you need to know what is considered higher education expenses and the requirements to be a qualifed student.
4. If you own a qualified retirement plan other than an IRA and are going through a divorce whereby your spouse is entitled to a portion of your assets, make sure the court issues you a QDRO as defined in §414(p)(1). The payments cannot come from an IRA.
5. You should clearly understand the conditions under which you may be classified as a first-time homebuyer. Also, distributions from an IRA must be used to buy the home within 120 days of the withdrawal date.

Planning is essential to ensure you do not miss the opportunity to take advantage of the §72(t)(2) exemptions.

If you have any questions about pending tax legislation, please contact our office for more details.

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