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Penalties for Early Withdrawals From Qualified Plans

-by Neil E. Harl*

Distributions from qualified plans before age 59 ½ are, in general, subject to a 10 percent penalty.[1] However, there are several exceptions to the general rule which afford planning opportunities for plan beneficiaries.

Exceptions to the rule of a 10 percent penalty

There are several major exceptions to the general rule that early distributions from qualified plans are subject to a 10 percent penalty.[2]

- A distribution on or after the death of a participant to the beneficiary is not subject to the penalty, as would be expected.[3] Moreover, a distribution from an "eligible retirement plan"[4] may be rolled over to an IRA or another qualified plan if the requirements are met.[5]
- A distribution because of disability of the participant is not subject to the penalty.[6] The disability exception did not apply in a 2007 case because the individual failed the test of being "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."[7]
- Plan benefits can be distributed in substantially equal periodic payments (on an annual or more frequent basis) over the life or life expectancy of the employee or the joint lives (or joint life expectancies) of the employee and the designated beneficiary.[8]
- Distributions made to an employee after separation from service after reaching age 55 are not subject to the penalty.[9] This exception does not apply to IRAs, only to other qualified plans.[10] The term "separation from service" is not defined in the statute or regulations. IRS has ruled that a senior executive who retired from full-time employment and continued to render services on a part-time basis as a consultant was considered to have separated from service.[11] However, to be assured of meeting the requirement, it would seem that the former employee should become an independent contractor, render services on an irregular basis and not be performing the same services as before.[12]
- Medical expenses paid for medical care to the extent the amount does not exceed the medical deduction are not subject to the penalty.[13]

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- Except for IRAs,[14] payments to an alternate payee pursuant to a Qualified Domestic Relations Order[15] are not subject to the penalty.[16]
- Distributions to unemployed individuals for health insurance premiums are not penalized.[17] However, this exception requires that the taxpayer have received unemployment compensation for 12 consecutive weeks.[18] This exception does not apply after the individual has been re-employed for at least 60 days after the separation from employment.[19] This exception applies also to self-employed individuals if the individual would have received unemployment compensation but for the fact the individual was self-employed.[20]
- Distributions from individual retirement accounts for higher education expenses incurred in the taxable year of the distribution are not subject to the penalty.[21]
- Distributions for first-time home purchases are not subject to the penalty.[22] This exception is limited to "qualified acquisition costs" with respect to a principal residence of a first-time homebuyer who is the taxpayer, spouse, child, grandchild or ancestor of the taxpayer or spouse.[23]
- An exception exists for loans from qualified plans if (1) a commercially-reasonable interest rate is charged, (2) there is "adequate security," and (3) the loan agreement is legally enforceable with a term of not more than five years (except for loans on dwellings).[24] A loan may be made up to 50 percent of the account balance is not considered a distribution.[25] A pledge is treated as a loan.[26]
- Distributions from some retirement plans may be repaid during the two-year period beginning on the day after the end of the active duty period for a reservist called to active duty after September 11, 2001 and before December 31, 2007.[27]

Attention to requirements

The exceptions to the rule of a 10 percent penalty for early withdrawals from qualified plans are both numerous and strict. Many of the cases that have been litigated in this area could have benefited from knowledgeable advice and counsel *before* the distributions were made.

FOOTNOTES

[1] I.R.C. § 72(t)(1), (2). See, e.g., Minteer v. Comm'r, 2006-1 U.S. Tax Cas. (CCH) ¶ 50,353 (9th Cir. 2006) (retirement fund distribution used to purchase gold coins was taxable; 10 percent penalty imposed); Armstrong v. United States, 2003-1 U.S. Tax Cas. (CCH) ¶ 50,473 (D. N.D. 2003), *aff'd*, 366 F.3d 622 (8th Cir. 2004) (early distribution of retirement annuity used to satisfy debt from personal loan included in income; assignment of plan documents was not mistake). See generally 7 Harl, *Agricultural Law* § 57.02[4][c][i] (2008); Harl, *Agricultural Law Manual* § 7.02[4][b][3] (2008); 2 Harl, *Farm Income Tax Manual* § 3.29[8][a] (2008 ed.).

[2] I.R.C. § 72(t)(2).

[3] I.R.C. 72(t)(2)(A)(ii).

[4] I.R.C. § 402(c)(8)(B).

[5] See I.R.C. § 402(c).

[6] I.R.C. § 72(t)(2)(A)((iii). See Rideaux v. Comm'r, T.C. Summary Opinion 2006-74; Ltr. Rul. 200718037, 60-day rollover period waived due to disability).

[7] I.R.C. §§ 72(t)(2)(A)(iii), 72(m)(7).

[8] I.R.C. § 72(t)(2)(A)(iv). See Notice 89-25, 1989-1 C.B. 632; Ltr. Rul. 200551032, Sept. 27, 2005 (IRA distribution not subject to 10 percent penalty for premature withdrawals where result was substantially equal periodic payments); Smith v. Comm'r, T.C. Summary Op. 2004-146 (exception did not apply where lump-sum distribution received); Ltr. Rul. 200551032, Sept. 27, 2005 (same). See also Ltr. Rul. 200503036, Oct. 25, 2004 (failure of IRA administrator to make annual distribution did not violate "substantially equal periodic payment" rule).

[9] I.R.C. § 72(t)(2)(A)(v). See Williams, Jr. v. Comm'r, T.C. Summary Op. 2008-53 (retirement at age 53; not eligible for exception); Olintz v. Comm'r, T.C. Summary Op. 2006-155 (individual at age 56 who separated from employer's service not liable for penalty).

[10] I.R.C. § 72(t)(3)(A).

[11] Rev. Rul. 69-647, 1969-2 C.B. 101.

[12] Reinhardt v. Comm'r, 85 T.C. 511 (1985) (employee-shareholder who sold equity interest in corporation and changed from employee to independent contractor but continued to perform the same services did not separate from employment for this purpose). See Bolden v. Comm'r, 39 T.C. 829 (1963) (no separation from service from former shareholder-employee who continued after sale of equity interest in advisory capacity). Compare Ridenour v. United States, 3 Cls. Ct. 128 (1983) (individual who continued to provide services had not separated form service even though status may have changed).

[13] I.R.C. § 72(t)(2)(B).

[14] I.R.C. § 72(t)(3)(A).

[15] I.R.C. § 414(p)(1).

[16] I.R.C. § 72(t)(2)(C).

[17] I.R.C. § 72(t)(2)(D).

[18] I.R.C. § 72(t)(2)(D)(i)(I).

[19] I.R.C. § 72(t)(2)(D)(ii).

[20] I.R.C. § 72(t)(2)(D)(iii).

[21] I.R.C. § 72(t)(2)(E). See Uscinski v. Comm'r, T.C. Memo. 2005-124 (401(k) accounts do not qualify for this exemption); Barbee v. Comm'r, T.C. Summary Op. 2006-71 (exception applies only to IRAs; irrelevant that taxpayer had IRAs from which distributions could have been made); Lodder-Becker v. Comm'r, T.C. Memo. 2005-162 (IRA distributions used to pay higher education expenses in year *before* distribution subject to 10 percent penalty); Ambata v. Comm'r, T.C. Summary Op. 2005-93 (IRA distribution used to pay qualified higher education expenses in year after distribution; 10 percent additional tax imposed); Nolan v. Comm'r, T.C. Memo. 2007-306 (secondary education expenses did not qualify as higher education); Gorski v. Comm'r, T.C. Summary Op. 2005-112 (expenditures for computer, housewares, furniture, appliances and bedding were not qualified higher education expenses). See also Domanico v. Comm'r, T.C.

Summary Op. 2006-55 (early distribution from 401(k) plan to pay wife's higher education expenses not within exception; was not an IRA as required).

[22] I.R.C. § 72(t)(2)(F). See Olup v. Comm'r, T.C. Summary Op. 2005-183 (couple ineligible for first-time homebuyer exception; husband had prior ownership interest in a principal residence (both must meet the requirement); Sharma v. Comm'r, T.C. Summary Op. 2008-98 (ownership previously of residence in joint tenancy precluded exception on early withdrawal; not "first-time homebuyer"). See also Ltr. Rul. 200829030, April 21, 2008 (intended to use distribution to purchase home but offer withdrawn).

[23] I.R.C. § 72(t)(8).

[24] Treas. Reg. § 1.72(p)-1. See Jordan v. Comm'r, 07-2 U.S.T.C. § 50,606 (1st Cir. 2007), *aff'g*, T.C. Memo. 2006-95 (taxpayer failed to show distributions from retirement plans were loans under I.R.C. § 72).

[25] Treas. Reg. § 1.72(p)-1.

[26] *Id.*

[27] I.R.C. § 72(t)(2)(G).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

BANKRUPTCY

GENERAL

AVOIDABLE TRANSFERS. The Chapter 7 debtor grain elevator had received a check on October 27, 2003, for soybeans sold by the debtor. The check was made out to the debtor and a bank, but the check was dishonored for lack of sufficient funds in the buyer's account. The check was replaced by a new identical check within the 90 days prior to the debtor's filing for bankruptcy. The second check was used to pay a loan to the bank, which released a lien on the soybeans. The Chapter 7 trustee sought to recover the payment, arguing that the replacement check was a payment without exchange for value. The Bankruptcy Court had agreed with the trustee but the District Court reversed, holding that the release of the lien after the receipt of the new check constituted a contemporaneous exchange for new value. The appellate court acknowledged that, in the usual circumstances, a dishonored check establishes an unsecured claim by the payee against the payor; therefore, replacement of a dishonored check with 90 days before a bankruptcy filing would be an avoidable transfer. However, because the bank in this case did not release its lien on the soybeans after the first check, the secured status of the claim remained and the replacement check was an exchange for new value from the release of the lien on the soybeans. **Velde v. Kirsch, 2008 U.S. App. LEXIS 20151 (8th Cir. 2008), *aff'g*, 366 B.R. 902 (D. Minn. 2007)**.

FEDERAL AGRICULTURAL PROGRAMS

BIOMASS CROP ASSISTANCE PROGRAM. The CCC has announced that it intends to prepare an Environmental Impact Statement (EIS) for the Biomass Crop Assistance Program (BCAP). BCAP is a new program authorized by the Food, Conservation, and Energy Act of 2008. The EIS will assess the potential environmental impacts of alternatives for administration and implementation of BCAP. As part of the EIS process, CCC is now soliciting input about potential alternatives for program implementation as well as potential environmental concerns associated with program implementation. CCC will develop and analyze a range of BCAP implementation alternatives. **73 Fed. Reg. 57047 (Oct. 1, 2008)**.

FARM LOANS. The FSA has issued proposed regulations amending its guaranteed farm loan program regulations governing interest rates to increase clarity and to be more consistent with other government loan guarantee programs. The proposed regulations tie the maximum interest rate that may be charged on FSA guaranteed farm loans to nationally published indices such as the Wall Street Journal Prime (also known as New York Prime), or the 10-year Treasury note rate unless the lender uses a formal written risk-based pricing model for loans, in which case the rate will be the rate charged to moderate risk borrowers. The proposed rule specifically asks for comments on the index to be used and the maximum allowable spread between the base rate and the rate to be charged to FSA guaranteed borrowers. **73 Fed. Reg. 56754 (Sept. 30, 2008)**.

NATIONAL ORGANIC PROGRAM. The AMS has announced that states may submit applications for federal assistance (Standard Form 424), and to enter into a cooperative agreement with the AMS for the allocation of National Organic Certification Cost-Share Funds. The AMS has allocated $22.0 million for its organic certification cost-share program commencing in Fiscal Year 2008. Funds are available under this program to interested states to assist organic producers and handlers certified under the National Organic Program, as appropriate. **73 Fed. Reg. 54555 (Sept. 22, 2008)**.

PACKERS AND STOCKYARDS ACT. The 2008 Farm Bill gave the GIPSA the responsibility of promulgating regulations with respect to the Packers and Stockyards Act, 1921 (7 U.S.C. 181 *et seq.*) to establish criteria to be considered in determining: (1) whether an undue or unreasonable preference or advantage has occurred in violation of the Act; (2) whether