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HEARTLESS TAX LAW

Beware when you or a family member must invade a qualified retirement account, for the ten percent penalty is imposed if you make an “early withdrawal” even if the withdrawal is due to a financial hardship. In a recent Tax Court summary opinion, to avoid the early distribution penalty, the hardship must fall within the definition of a “qualifying” hardship. In the case I am about to describe, the distribution from the qualifying retirement plan was therefore subject to the ten percent additional tax under Code Section 72(t).

In August 2001, Stacy Reese’s former husband was involved in a diving accident and became a quadriplegic. Stacy worked from August 2001 to September 2003, but she quit at the end of 2003 to care for her two young children. During 2003, because of financial hardship, Stacy, who at that time was under age 55, took a lump-sum distribution from the 401(k) account maintained by her former employer. She used the money to pay normal day-to-day living expenses. When she filed her tax return for 2003, Stacy reported the distribution as income. The IRS sent her a statutory notice of deficiency and held her liable for a ten percent additional tax on the distribution under Code Section 72(t) on the grounds that she received the distribution “prematurely”.

THE PREMATURE DISTRIBUTIONS TAX:

Code Section 72(t)(1) generally imposes a ten percent additional tax on premature distributions from “a qualified retirement plan”. 401(k) plans ARE qualified retirement plans. The only exceptions to this tax penalty are certain distributions which fall within one of the narrowly specified Section 72(t)(2) statutory exceptions.

PURPOSE OF THE TAX:

The legislative purpose underlying the section 72(t) tax is that “premature distributions from IRAs frustrate the intention of saving for retirement, and section 72(t) discourages this from happening”.

Courts have, over and over again, declared sympathy for taxpayers but have nevertheless cried that they are bound by the statutory exceptions enumerated in the Code. Stacy’s argument was that she did have a “qualifying hardship”. The court didn’t disagree that she had a hardship. Its opinion expressed sympathy, but apparently that sympathy wasn’t enough.

It also wasn’t enough where taxpayers took distributions due to financial hardship and used the money to pay bills, tuition at their son’s private high school, and other personal expenses or where the distribution was used for the taxpayer’s “own subsistence and that of her family” or used to pay off debts. Since Stacy didn’t show her situation fell within any of the exceptions to the ten percent additional tax under section 72(t)(2), she loses.

ENUMERATED EXCEPTIONS:

So what are the exceptions under 72(t)(2)?

Generally, the following are the EXEMPTED Distributions: Those

- made on or after the date on which the employee attains age 59½,
- made to a beneficiary (or to the estate of the employee) on or after the death of the employee,
- attributable to the employee’s being disabled,
- 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,
- made to an employee after separation from service after attainment of age 55, or
- made on account of certain levies under the Code.

It’s sad and really unforgivable that our laws and courts are so inflexible in a situation such as Stacy Reese’s. Isn’t it ironic that our wise Congress seeks to protect us from our own folly and lack of fiscal discipline (the current deficit proves that the members of Congress are competent instructors). I get sickened reading about some unfortunate soul, who gets to suffer even more when she accidentally steps on a tax land mine. Our tax laws should do better. We, as taxpayers need to hold Congress and the White House accountable.

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