Chapter 1: Retirement Plan Distributions

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Please note. Corrections were made to this workbook through January of 2021. No subsequent modifications were made.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

About the Author

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Throughout the 2020 *University of Illinois Federal Tax Workbook,* there are topics affected by recent major legislation, notably the Coronavirus Aid, Relief, and Economic Security (CARES) Act of 2020, and the Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019. For the reader's convenience in locating these issues, there are icons in the left margin highlighting areas of impact and their source.

CARES Act

SECURE Act

EARLY WITHDRAWAL PENALTIES FROM IRAs OR QUALIFIED PLANS

Individual retirement arrangements (IRAs) and other qualified retirement plans were established to encourage U.S. taxpayers to save for retirement. To discourage people from withdrawing the funds before retirement age, most early withdrawals are subject to a 10% penalty in addition to the income taxes due on the withdrawal. Only the taxable portion of the withdrawal is subject to penalty.[1]

An early withdrawal is defined as any withdrawal made before the taxpayer reaches age 59½.[2] The Code includes several exceptions to the penalty for early withdrawal. However, the exceptions do not apply universally to all tax-favored retirement plans. Generally, for these purposes, tax-favored retirement plans can be grouped into two categories: qualified plans and IRAs. Governmental 457(b) distributions are not subject to the 10% additional tax except for distributions attributable to rollovers from another type of plan or IRA.The table at the end of this section summarizes the penalty exceptions by category.

CORONAVIRUS-RELATED DISTRIBUTION

The Coronavirus Aid, Relief, and Economic Security (CARES) Act eliminates the **10% penalty** on **coronavirus-related distributions.** Coronavirus-related distributions are distributions up to $100,000 from an eligible retirement plan (as defined in IRC §402(c)(8)(B)) made during calendar year 2020. The distribution must be to an individual who meets **one** of the following requirements.[3]

1. Was diagnosed with the virus SARS-CoV-2 or with coronavirus disease 2019 (COVID-19) by a test approved by the Centers for Disease Control and Prevention
2. Whose spouse or dependent (as defined in IRC §152) was diagnosed with the virus or disease by such a test
3. Experiences adverse financial consequences as a result of being quarantined, being furloughed or laid off or having work hours reduced due to such virus or disease, being unable to work due to lack of child care due to such virus or disease, closing or reducing hours of a business owned or operated by the individual due to such virus or disease, or other factors as determined by the Secretary of the Treasury (or the Secretary's delegate)

Coronavirus-related distributions may be repaid during a 3-year period beginning on the day after the date the distribution was received. Amounts that are repaid are treated as a trustee-to-trustee transfer and are not included in income.[4]

The distribution amount is included in income ratably over a 3-year period, unless the taxpayer elects otherwise. If the taxpayer makes such an election, they include the entire distribution in their income in the year they receive it.[5]

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1. IRC §72(t)(1).
2. IRC §72(v)(2)(A).
3. PL 116-136, §§2202(a)(1) and (a)(4)(A).
4. PL 116-136, §2202(a)(3).
5. PL 116-136, §2202(a)(5).

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Practitioner Planning Tip

Although distributions may be exempt from the 10% penalty, the distributions are not exempt from income tax. Taxpayers who experience lower than normal income in 2020 may benefit from reporting the entire distribution amount in 2020 rather than over three years.

ARGUMENTS THAT DID NOT PERSUADE THE COURTS

IRC §72(t), covering exceptions to the 10% penalty, was added to the Code by the Tax Reform Act of 1986.[6] It applies to any early distribution from a qualified retirement plan that is includable in the taxpayer's gross income.[7]

Over the years, taxpayers have made numerous arguments to the IRS and the courts that their situation should qualify for an exception to the 10% penalty. The following arguments were **specifically rejected.**

- **Hardship.** There is no general hardship exception. Only the hardships specifically enumerated in the Code allow taxpayers to avoid the 10% early withdrawal penalty.[8] Although some §401(k) and §403(b) plans allow employees to take hardship distributions, the designation under those rules is **not** an exception to the 10% penalty.
- **Mandatory distributions.** Certain retirement plans may require participants to cash out their balances under specific circumstances. Despite the mandatory nature of such distributions, the penalty applies.[9]

Note. Taxpayers can **roll over** mandatory distributions to another qualified plan or an IRA to avoid the income tax and penalty.

- **Loans treated as distributions.**[10] Certain retirement plans may allow participants to take loans from their accounts. Qualified loans are not treated as distributions. However, if the participant fails to meet the loan requirements, the entire remaining loan balance is treated as a distribution. This deemed distribution is subject to income tax and the 10% penalty, if applicable.

Note. Loans treated as distributions are discussed later in this chapter.

Example 1. In 2017, Garland obtained a $30,000 loan from his 401(k) plan. Under the terms of the loan agreement, loan payments were withdrawn from his weekly paycheck. On January 31, 2019, when he was 52 years old, he left his employer. Under the terms of the employer's plan, the loan became due immediately.

Garland did not remedy the default. The amount of the deemed distribution was the $12,000 he still owed. The $12,000 was subject to income tax and the 10% penalty.

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6. *Lesson From The Tax Court: Know The Difference Between IRAs And 401(k)s.* Camp, Bryan. Aug. 12, 2019. Law Professor Blogs, LLC. [taxprof.typepad.com/taxprof_blog/2019/08/lesson-from-the-tax-court-.html] Accessed on Dec. 27, 2019.

7. IRS Notice 87-13, 1987-1 CB 432, Q&A 20.

8. *Duffy v. Comm'r*, TC Memo 1996-556 (Dec. 23, 1996); *Pulliam v. Comm'r*, TC Memo 1996-354 (Aug. 1, 1996); *Arnold v. Comm'r*, 111 TC 250, 255 (1998); *Milner v. Comm'r*, TC Memo 2004-111 (May 4, 2004); *Robertson v. Comm'r*, TC Memo 2000-100 (Mar. 24, 2000), *aff'd* 15 Fed. Appx. 467 (9th Cir. 2001).

9. IRS Notice 87-13, 1987-1 CB 432, Q&A 20.

10. Treas. Reg. §1.72(p)-1.

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Throughout the remainder of these sections, the various penalty exceptions are marked with icons to clearly identify whether they apply (✔) or do not apply (✗) to IRAs and qualified plans (QP).

IRA: ✔ QP: ✔ AGE EXCEPTION[11]

Distributions made on or after the date on which the taxpayer reaches age 59½ are not subject to the 10% penalty.

> **Caution.** If a taxpayer who is over age 59½ receives a Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,* that indicates the distribution was early, the early distribution code (box 7, code 1) may be correct. Code 1 must be used even if the taxpayer is age 59½ or older if the taxpayer modifies a series of substantially equal periodic payments (discussed later) prior to the end of the 5-year period that began with the first payment.[12]

IRA: ✔[13] QP: ✔ AUTOMATIC ENROLLMENT EXCEPTION[14]

Some employers have retirement plans that automatically enroll all eligible employees into the plan with a default rate for elective contributions by the employees to the plans. These plans may allow employees who have been automatically enrolled to elect to "unenroll" and have their contributions returned (plus attributable earnings). The unenrollment election must be made within 90 days of the first default contribution. Distributions received due to this election are not subject to the early withdrawal penalty.

IRA: ✔ QP: ✔ BIRTH OR ADOPTION EXCEPTION[15]

For distributions made after December 31, 2019, taxpayers may withdraw up to $5,000 from a retirement plan during the 1-year period beginning on the date a child of the individual is born. This rule also applies during the 1-year period beginning on the date on which the legal adoption by the individual of an eligible adoptee is finalized. An eligible adoptee is any individual (other than a child of the taxpayer's spouse) who is under age 18 or mentally incapable of self-support.

To claim the exception, the taxpayer must include the name, age, and taxpayer identification number of the child or adoptee on the tax return for the year of distribution.[16]

> **Note.** This Code provision was added by the SECURE Act, which was enacted on December 20, 2019. The Act also includes an option for taxpayers to return these distributions into their retirement plans as if the contributions were rollovers. For more information, see the 2020 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: New Developments.

Example 2. Kyrie's daughter, Lilly, was born on February 25, 2019. On January 31, 2020, when Kyrie was 32, she withdrew $4,000 from her IRA. This distribution is not subject to the 10% penalty for early withdrawal because it was made during the 1-year period after Kyrie's daughter was born.

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11. IRC §72(t)(2)(A)(i).
12. Instructions for Forms 1099-R and 5498; See also IRC §72(t)(4).
13. This only applies to SIMPLE IRAs and SARSEPs.
14. IRC §414(w).
15. IRC §72(t)(2)(H).
16. IRC §72(t)(2)(H)(vi)(III).

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IRA: ✗ QP: ✔ CORRECTIVE DISTRIBUTIONS EXCEPTION[17]

An employee may receive a distribution from a qualified plan if the deferral or contribution amount is in excess of applicable limits. These distributions are not subject to the early withdrawal penalty if the distribution is made by April 15 following the close of the year in which the excess was contributed.

IRA: ✔ QP: ✔ DEATH EXCEPTION[18]

Distributions made to a beneficiary on or after the death of the account holder are not subject to an early withdrawal penalty. However, this exception may not apply when a taxpayer elects to treat their deceased spouse's IRA as their own if the taxpayer takes a distribution before they reach age 59½.[19]

IRA: ✔ QP: ✔ DISABILITY EXCEPTION[20]

Distributions made after the taxpayer becomes disabled are not subject to the 10% penalty. Disability is defined as the inability "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."[21] The Code states that an individual will not be considered disabled unless they furnish proof of the disability in such form and manner as the IRS may require. The proof must be a **medical determination of disability;** however, the IRS does not require that the proof be submitted with the return.[22]

Defining Disability[23]

In determining whether an individual's impairment makes them unable to engage in any substantial gainful activity, primary consideration is given to the nature and severity of the impairment. Consideration is also given to other factors such as the individual's education, training, and work experience. **Gainful activity** refers to the activity, or a comparable activity, in which the individual customarily engaged prior to the disability (or prior to retirement if the individual was retired at the time the disability arose.)

The following are examples of impairments that would ordinarily be considered as preventing substantial gainful activity.

- Loss of use of two limbs
- Certain progressive diseases that have resulted in the physical loss or atrophy of a limb, such as diabetes, multiple sclerosis, or Buerger's disease
- Diseases of the heart, lungs, or blood vessels that have resulted in major loss of heart or lung reserve as evidenced by X-ray, electrocardiogram, or other objective findings, so that despite medical treatment, breathlessness, pain, or fatigue is produced on slight exertion, such as walking several blocks, using public transportation, or doing small chores
- Cancer that is inoperable and progressive
- Damage to the brain or brain abnormality that has resulted in severe loss of judgment, intellect, orientation, or memory
- Mental diseases (e.g., psychosis or severe psychoneurosis) requiring continued institutionalization or constant supervision of the individual

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17. IRC §§401(k)(8)(D), 401(m)(7)(A), and 402(g)(2)(C).
18. IRC §72(t)(2)(A)(ii).
19. IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements (IRAs).*
20. IRC §72(t)(2)(A)(iii).
21. IRC §72(m)(7).
22. Instructions for Form 5329.
23. Treas. Reg. §1.72-17A(f).

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- Loss or diminution of vision to the extent that the affected individual has a central visual acuity of no better than 20/200 in the better eye after best correction, or has a limitation in the fields of vision such that the widest diameter of the visual fields subtends an angle no greater than 20 degrees
- Permanent and total loss of speech
- Total deafness not correctible by a hearing aid

The existence of one or more of the impairments described above does not, however, always permit a finding that an individual is disabled. Any impairment, whether of lesser or greater severity, must be evaluated in terms of whether it does in fact prevent the individual from engaging in their customary or any comparable substantial gainful activity.

An impairment must be expected either to continue for a long and indefinite period or to result in death. Ordinarily, a terminal illness because of disease or injury would result in disability. The term "indefinite" is used in the sense 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.

An impairment that is remediable does not constitute a disability. An individual will not be deemed disabled if, with reasonable effort, the impairment can be diminished to the extent that the individual will not be prevented by the impairment from engaging in their customary or any comparable substantial gainful activity.

Example 3. Carol worked as a nurse. When she was 44, she was in a car accident that caused permanent damage to both of her legs. After her surgery in 2018, she withdrew $20,000 from her IRA. At the time of the withdrawal, it was not known if she would be able to return to work. The withdrawal was coded as an early distribution. Carol reported the income and paid the 10% penalty with her 2018 return.

In 2020, Carol was awarded social security disability benefits retroactive to the date of the accident. Meeting the disability guidelines for social security purposes could provide sufficient evidence to the IRS that the taxpayer meets the disability exception. Carol's CPA filed an amended return for 2018 to recover the 10% penalty, arguing that the award of social security disability benefits proved that the distribution was on account of disability and therefore not subject to the early withdrawal penalty.

Example 4. Kathryn developed a gambling problem as a side effect of her prescription medication. Before she turned 59½, while under the medication's effects, she withdrew funds from her IRA. She and her husband argued to the court that the IRA withdrawal was not subject to the early withdrawal penalty because the compulsive gambling was a mental illness qualifying as a disability. The court found that Kathryn's impairment was remediable and therefore not a disability.[24]

Note. For more information about *Gillette v. Comm'r*, which was the basis for this example, see the 2019 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 4: Rulings and Cases.

Example 5. Christopher withdrew $44,000 from his IRA when he was younger than 59½. Although he was ill, he continued to work. His illness did not prevent him from engaging in substantial gainful activity. Therefore, the distribution was subject to the 10% penalty.[25]

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24. This example is taken from the facts and conclusions in *Gillette and Szczepanski v. Comm'r,* TC Memo 2018-195 (Nov. 20, 2018).

25. This example is taken from the facts and conclusions in *Totten v. Comm'r,* TC Summ. Op. 2019-1 (Jan. 29, 2019).

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IRA: ✔ QP: ✔ DISASTERS EXCEPTION[26]

The 10% early withdrawal penalty does not apply to qualified disaster distributions. The Further Consolidated Appropriations Act, 2020 (FCAA), which was enacted on December 20, 2019, established provisions related to qualified disaster distributions of up to $100,000. These provisions only apply to federally declared disasters occurring between January 1, 2018, and February 18, 2020 (60 days after the date of enactment of the FCAA), except the California wildfire disaster area defined in the Bipartisan Budget Act of 2018.

Qualified disaster distributions for disasters occurring during the relevant period are those distributions from an eligible retirement plan that meet the following conditions.

1. Made on or after the first day of the incident period of a qualified disaster and before June 17, 2020
2. Made to an individual whose main home at any time during the incident period of the disaster was in the qualified disaster area
3. That individual sustained an economic loss because of the disaster

Qualified disaster distributions are included in the taxpayer's income in equal amounts over three years. However, the taxpayer can make an election to include the entire distribution in their income in the year they receive it.

As mentioned earlier, qualified disaster distributions are not subject to the 10% additional tax on early distributions from qualified retirement plans. However, any distributions the taxpayer received in excess of the $100,000 limit may be subject to the additional tax on early distributions.

A taxpayer can generally repay any portion of a qualified disaster distribution that is eligible for tax-free rollover treatment to an eligible retirement plan. The taxpayer has three years from the day after the date they received the distribution to make a repayment. Amounts that are repaid are treated as a trustee-to-trustee transfer and are not included in income.

Note. For more information about the FCAA, including disaster-related rules for the use of retirement funds, see the 2020 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: New Developments.

IRA: ✗ QP: ✔ DOMESTIC RELATIONS ORDER EXCEPTION[27]

Payments from a qualified retirement plan to an alternate payee under a qualified domestic relations order (QDRO) are exempt from the 10% penalty. A QDRO is a court order assigning the right to receive benefits under a retirement plan to another person.[28] To be qualified, the court order must relate to child support, alimony, or marital property rights under domestic relations laws and satisfy the other requirements of IRC §414(p).

An alternate payee may be any spouse, former spouse, child, or other dependent of the plan participant.[29] Benefits paid to a spouse or former spouse generally are taxed to the recipient. However, the spouse or former spouse may roll over the funds tax-free to another qualified plan or IRA.[30]

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26. The Further Consolidated Appropriations Act, 2020, Division Q (The Taxpayer Certainty and Disaster Tax Relief Act of 2019), §§201-205; IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements (IRAs).*
27. IRC §72(t)(2)(C).
28. IRC §414(p).
29. IRC §414(p)(8).
30. IRS Pub. 504, *Divorced or Separated Individuals.*

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The plan must be a qualified pension, profit-sharing, or stock bonus plan.[31] Accordingly, distributions from IRAs, simplified employee pension (SEP), savings incentive match plan for employees (SIMPLE) IRAs, and salary reduction simplified employee pensions (SARSEP), do not qualify for this exception.[32] Although the QDRO exception does not apply to IRAs, the Code does provide that transfers of an individual's interest in an IRA to a spouse or former spouse are exempt from taxation and the 10% penalty.[33] These transfers must be pursuant to a divorce or separation agreement.[34]

Example 6. Under the terms of their divorce, the court ordered that 50% of Karen's 401(k) be distributed to Conall. The appropriate documentation was provided to Karen's employer in 2019 and Conall received the distribution shortly thereafter. Conall received a Form 1099-R from the employer's plan administrator showing that the distribution was taxable and indicating with code 2 in box 7 that it was not subject to the 10% penalty.

Caution. Historically, the IRS has frequently requested copies of the QDRO when the distribution was reported using code 1 in box 7 of the Form 1099-R and the QDRO exception was reported on Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts.* Practitioners should obtain a copy of the agreement prior to claiming the exception. In addition, attaching the copy to the return might curtail the possibility of an audit. Taxpayers should also be advised that the IRS might send them a notice assessing the 10% penalty with a request for a copy of the QDRO even if the document was attached to the return.

Example 7. Under the terms of their divorce, the court ordered John to pay Sue $30,000 for her share of their marital property. John was under age 59½ at the time he withdrew $30,000 from his 401(k) plan to pay the court-ordered property settlement. Because the court did not order the funds to be paid to Sue from the 401(k) plan, the court order was not a QDRO. John must claim the income and pay the 10% penalty for early withdrawal.

Practitioner Planning Tip

There is no prohibition against both parties to a divorce receiving QDRO distributions. Cooperative and creative planning could give both divorcing taxpayers access to retirement funds without paying the 10% early withdrawal penalty.

31. *Retirement Topics - Exceptions to Tax on Early Distributions.* Oct 29, 2019. IRS. [www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-tax-on-early-distributions] Accessed on Dec. 16, 2019.

32. IRC §72(t)(3)(A).

33. IRC §408(d)(6).

34. See IRC §121(d)(3)(C).

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Example 8. Mary and Tom are in the middle of a divorce. They would like to settle certain debts prior to separating, but their entire savings are tied up in their 401(k) plans with their respective employers. As part of the divorce proceedings, they ask the court to issue a QDRO for Tom's retirement administrator to distribute money from his account to Mary. They also ask the court to issue a QDRO for Mary's retirement administrator to distribute money from her account to Tom. In this way, neither distribution is subject to the 10% early withdrawal penalty, although both distributions are subject to income tax.

Caution. The QDRO exception only applies to distributions directly from the employer plan. If the receiving spouse elects to roll over the funds into their own IRA, the QDRO exception will not apply to distributions from the IRA.

IRA: ✔ QP: ✗ EDUCATION EXCEPTION[35]

Distributions are not subject to the 10% penalty to the extent that they are used for qualified higher education expenses. This exception applies **only to distributions from IRAs.**

Example 9. Christine withdrew $67,553 from her 403(b) plan that was sponsored by the school system where she worked. She used the proceeds to pay for her daughter's higher education expenses. Because a 403(b) plan is not considered an IRA and only IRA distributions qualify for an exception to the penalty, the distribution was subject to the 10% early withdrawal penalty.[36]

Practitioner Planning Tip

It may be prudent to advise qualified plan participants to consider borrowing from their QP instead of making a withdrawal.

The term "qualified higher education expenses"[37] incorporates the definitions from several other Code provisions.

- Qualified expenses for these purposes are the same as those defined as qualified for tax-free distributions from 529 plans. This includes the following.
  - Tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution
  - Expenses for special-needs services in the case of a special-needs beneficiary that are incurred in connection with such enrollment or attendance
  - Expenses for the purchase of computer or peripheral equipment (as defined in IRC §168(i)(2)(B)), computer software (as defined in IRC §197(e)(3)(B)), or Internet access and related services, if such equipment, software, or services are to be used primarily by the student during any of the years the student is enrolled at an eligible educational institution

35. IRC §72(t)(2)(E).

36. This example is taken from the facts and conclusions in *Gibbons v. Comm'r,* TC Summ. Op. 2006-106 (Jul. 13, 2006). See also *Uscinski v. Comm'r*, TC Memo 2005-124 (May 25, 2005).

37. IRC §72(t)(7)(A).

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- **Room and board** for students who attend at least half-time (Room and board must be incurred while attending the institution. If the student lives in school-provided housing, the amount is determined by the actual amount charged by the school for the room and board. If the student does not live in school-provided housing, the amount claimed cannot exceed the allowance for room and board included in the cost of attendance as determined by the eligible educational institution for such period. The allowance[38] is the room and board amount that the school uses in calculating the financial aid cost of attendance.)

- The student must be the taxpayer, the taxpayer's spouse, or any child (as defined in IRC §152(f)(1)) or grandchild of the taxpayer or the taxpayer's spouse.
- The education must be provided at an eligible educational institution (as defined in §529(e)(5)).

The amount of qualified higher education expenses does **not** include any costs covered by tax-free scholarships or grants.[39]

Example 10. Richard withdrew approximately $110,000 from his IRA in 2006. He and his wife, Robin, used $80,000 of the distribution to pay off outstanding credit card debt and set aside $8,000. The remaining balance of the distribution was withheld for federal income tax.

The IRS imposed the 10% penalty on the withdrawal. Richard and Robin argued that the withdrawal was made because of their financial hardship. The court rejected that argument, but it did allow them to exclude the amount the taxpayers spent for higher education from the penalty.

To determine the amount they spent for higher education, the court noted that Richard and Robin's daughter's tuition was paid by a 529 plan, so the tuition was not included in the amount spent. The taxpayers did not have any records of the amounts given to their daughter for her education, but they were able to convince the court that they spent $575 per month for rent and $100 per month for utilities in addition to $100 for food. However, the court noted that the amount treated as higher education expenses for this purpose is limited to the allowance for room and board included in the cost of attendance as determined by the university their daughter attended. The court ordered the IRS to apply the higher education exception accordingly for each month the daughter was enrolled at the university.[40]

Note. In the *Venet* case used as the basis for **Example 10,** the court did not require the taxpayers to show that the funds distributed could be traced to the higher education expenses.

Practitioner Planning Tip

The taxpayers may have benefited from treating the 529 distribution as nonqualified in order to potentially have more of the IRA distributions qualify for exceptions to the 10% penalty.

38. IRC §529(e)(3)(B)(ii)(I) refers to §472 of the Higher Education Act of 1965 (20 USC 1087ll), as in effect on the date of the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001.

39. IRS Pub. 970, *Tax Benefits for Education.*

40. This example is taken from the facts and conclusions in *Venet v. Comm'r,* TC Memo 2009-268 (Nov. 24, 2009).

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IRA: ✔ QP: ✔ SUBSTANTIALLY EQUAL PAYMENTS EXCEPTION[41]

Certain distributions that are part of a series of substantially equal payments are exempt from the 10% penalty even if they begin before the taxpayer reaches age 59½. To qualify, the distributions must be taken at least annually and be determined using one of the IRS-approved calculation methods designed to spread the distributions over the taxpayer's life expectancy (or joint life expectancies of the taxpayer and the designated beneficiary of the account).[42]

For distributions from **qualified plans**, the payments cannot begin before the employee has ceased working for the employer who provided the plan.[43] This rule does not apply to IRAs.

There is a significant trap related to this exception. If the method of calculating the distribution is modified, a recapture tax applies to any payments received **before** the taxpayer reached 59½. The substantially equal payments must also continue for at least five years even if the taxpayer turns 59½ before the 5-year window closes. The 5-year window **begins** on the date of the first payment. The amount of the recapture tax is the amount that would have been imposed if the exception did not apply, plus interest for the deferral period.

Example 11. Arnold began withdrawing his IRA funds in December 2014 when he was 55 years old. To avoid any early withdrawal penalty, he had the distribution amount calculated by an actuary using an IRS-approved method. The distributions were as follows.

December 2014	$44,000
January 2015	44,000
January 2016	44,000
January 2017	44,000
January 2018	44,000
November 2018	6,776

The 5-year period for maintaining the systematic withdrawal began December 2014 and ended December 2019. Accordingly, the November 2018 distribution modified the series of substantially equal payments.

Because of the November 2018 distribution, Arnold had to pay the 10% penalty on all the distributions made prior to the time he reached age 59½.

Arnold argued to the Tax Court that the five payments satisfied the 5-year rule. The court determined that this clearly was not true. Arnold also argued that the November 2018 payment was part of a cost-of-living adjustment as allowed under approved methods. The court dismissed this argument because there was no evidence that the payment was calculated as part of making such an adjustment. The court acknowledged that the distribution was made as a result of a financial hardship. However, they dismissed that fact as irrelevant because there is no exception to the 10% penalty for financial hardship.[44]

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41. IRC §72(t)(2)(A)(iv); IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements (IRAs).*

42. See Rev. Rul. 2002-62, 2002-2 CB 710 for approved methods.

43. IRC §72(t)(3)(B).

44. This example is based on the facts and conclusions in *Arnold v. Comm'r,* 111 TC 250 (Sep. 28, 1998).

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There is no general hardship exception for failure to continue using the same method to determine distributions.[45] However, there are some escape hatches for this trap.

- Death[46]
- Disability[47]
- Distributions to qualified public safety employees in governmental plans if the distributions meets the terms of §72(t)(10)[48]
- One-time switch to the required minimum distribution method for the current and future payments[49]

Distributions that satisfy one of the other penalty exceptions do not count as changing the method of calculating the substantially equal payments.[50]

> **Example 12.** Kimberly began taking distributions from her IRA under a plan of systematic withdrawal in 2016. During 2018, she received two additional distributions of $20,000 and $2,500, respectively. She was below age 59½ when she received the distributions.
>
> Kimberly used the additional distributions to pay for her son's qualified higher education expenses. The IRS issued a notice of deficiency, imposing the 10% penalty on her distributions under the argument that the withdrawal for higher education expenses modified the series of substantially equal periodic payments. The court determined that because Congress had specifically authorized more than one exception to the early withdrawal penalty, taxpayers are eligible to use distributions for differing purposes and still qualify for the applicable exceptions.[51]

Note. If the assets of the account are exhausted as a result of following an acceptable method of determining the substantially equal periodic payments, the failure to take distributions from the exhausted account is not a change in method.[52]

IRA: ✗ QP: ✔ EMPLOYEE STOCK OWNERSHIP PLAN EXCEPTION[53]

Under the rules for employee stock ownership plans (ESOPs) established under IRC §404(k), corporations may distribute dividends paid on the stock to employees. These distributions are not treated as retirement distributions even though they are paid from a qualified account. The Code specifically excludes these dividends from the 10% penalty.

Note. Dividends under these plans that are paid directly to the participants are reported on Form 1099-DIV, *Dividends and Distributions,* as ordinary dividends (but not qualified dividends).[54]

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45. *Arnold v. Comm'r,* 111 TC 250 (Sep. 28, 1998).
46. IRC §72(t)(4)(A)(ii).
47. Ibid.
48. Ibid.
49. Rev. Rul. 2002-62, 2002-2 CB 710.
50. *Benz v. Comm'r,* 132 TC 330 (May 11, 2009).
51. This example is based on the facts and conclusions in *Benz v. Comm'r,* 132 TC 330 (May 11, 2009).
52. Rev. Rul. 2002-62, 2002-2 CB 710.
53. IRC §72(t)(2)(A)(vi).
54. Instructions for Form 1099-DIV.

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IRA: ✔ QP: ✗ FIRST-TIME HOMEBUYERS EXCEPTION[55]

Qualified first-time homebuyers may take up to $10,000 from their **IRAs** during their lifetimes for the purpose of acquiring or constructing a principal residence without paying the 10% penalty. If the taxpayer is married, the spouse also is eligible to withdraw $10,000 from their IRA in the same year. The following rules apply.

1. The distribution must be used before the close of the 120th day after the day on which the payment is received. If there is a delay or cancellation of the purchase, the penalty may be avoided by redepositing the distribution into an IRA by the 120th day after the distribution is received.

2. The first-time homebuyer must be one of the following people.

   a. The taxpayer

   b. The taxpayer's spouse

   c. A child, grandchild, or ancestor of the taxpayer or their spouse

3. A first-time homebuyer is an individual (and if married, such individual's spouse) who has had no present ownership in a principal residence during the 2-year period ending on the date of acquisition of the qualifying principal residence. If the first-time homebuyer is a child, the child must meet this requirement. The acquisition date is either the date on which a binding contract to acquire the residence is entered into or the date on which construction/reconstruction of the residence commences.

Example 13. Keith was an accountant at Deloitte & Touche, where he participated in the 401(k) plan. He resigned in September 2016 to begin full-time studies in a Ph.D. program. In 2018, he received a distribution of approximately $30,000 from the 401(k) plan. He used the funds to pay school expenses and purchase his first home. He was not yet 59½ years old at the time of the distribution.

Keith tried to convince the court that the 10% penalty should not apply because he used the funds for allowable purposes even though those exceptions only apply to withdrawals from IRAs. He argued that he could have transferred the funds from the 401(k) to an IRA and that the difference between the two retirement plans is only a matter of form. The court was sympathetic but was bound by the statutory exceptions contained in §72(t)(2).[56]

IRA: ✔ QP: ✔ LEVY EXCEPTION[57]

The 10% penalty does not apply to amounts levied on a qualified retirement plan by the IRS.

Example 14. David and his wife, Barbara, withdrew nearly $70,000 from their IRAs in 2018. Neither of them had reached age 59½. They used approximately $7,000 of the funds to pay their outstanding California income tax liability and about $10,000 to pay their 2014 federal income tax liability.

They argued that the $70,000 should not be subject to the 10% early withdrawal penalty because they had reasonable cause to withdraw the funds and an exception should apply to distributions used to pay outstanding state/federal income tax liabilities. However, the court found that the penalty was not excused under the Code for either of those reasons.[58]

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55. IRC §§72(t)(2)(F) and 72(t)(8).

56. This example is based on the facts and conclusions in *Jones v. Comm'r,* TC Summ. Op. 2005-173 (Nov. 29, 2005). See also *Lily Hilda Soltani-Amadi and Bahman Justin Amadi v. Comm'r,* TC Summ. Op. 2019-19 (Aug. 8, 2019).

57. IRC §72(t)(2)(A)(vii).

58. This example is based on the facts and conclusions in *Pritchard v. Comm'r,* TC Memo 2017-136 (Jul. 10, 2017).

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Practitioner Planning Tip

Practitioners should advise clients to request that the IRS levy the funds before using retirement plan funds to satisfy tax debt.

MEDICAL EXCEPTIONS

IRA: ✔ QP: ✔ Unreimbursed Medical Expenses[59]

Distributions used to pay medical expenses are exempt from the penalty, but only to the extent that the taxpayer's unreimbursed medical expenses exceed the **applicable threshold** for the **year of the distribution**. The taxpayer does not have to itemize to use this exception.

The applicable threshold was 7.5% of the taxpayer's adjusted gross income (AGI) for 2017 and 2018. The FCAA temporarily continued the threshold at 7.5% for tax years 2019 and 2020.[60]

Example 15. Jeanette withdrew over $17,000 from her qualified retirement plan in 2017. She withdrew the funds to pay for medical treatments that she started in 2017. However, most of the medical bills were paid in 2018. She and her husband itemized their deductions for 2017, and they did not claim a deduction for medical expenses.

Jeanette argued that the distribution was used to pay medical expenses and therefore was not subject to the 10% penalty. The court ruled that the exception includes only those distributions used for deductible medical expenses paid in the same tax year that the distribution was made.[61]

Example 16. Use the same facts as **Example 15,** except Jeanette withdrew the funds in 2018. On her return for 2018, Jeanette claimed medical expenses totaling $16,253. After the 7.5% limitation, she was allowed an itemized deduction of $8,724. In this situation, only $8,724 of the $17,000 distribution qualified for the exception to the 10% penalty.

IRA: ✔ QP: ✗ Health Insurance Premiums When Unemployed[62]

Distributions from an IRA to an unemployed taxpayer used to pay health insurance premiums are exempt from the penalty if all the following tests are met.

1. The taxpayer has received unemployment compensation for 12 consecutive weeks.
2. The distribution is made during the same year as the unemployment benefits are paid or during the succeeding year.
3. The health insurance premiums are for the taxpayer, the taxpayer's spouse, and/or for the taxpayer's dependents. For this purpose, a person may qualify as a dependent even if they fail certain dependency tests. Specifically, even if a person is not a dependent for tax purposes, this exception can be used if the person would be a dependent but for the dependency test of IRC §152(b)(1), the married filing jointly test of §152(b)(2), or the gross income test of §152(d)(1)(B).

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59. IRC §72(t)(2)(B).
60. IRC §213(f); The Taxpayer Certainty and Disaster Relief Act of 2019, §103.
61. This example is based on the facts and conclusions in *Kimball v. Comm'r,* TC Summ. Op. 2004-2 (Jan. 8, 2004).
62. IRC §72(t)(2)(D).

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The exception does not apply after the individual has been re-employed for 60 days or more.

A self-employed individual is generally treated as receiving unemployment benefits if the only reason they did not receive them was that self-employed taxpayers do not qualify for unemployment benefits under federal or state law.

IRA: ✔ QP: ✔ MILITARY EXCEPTION[63]

Distributions from retirement plans or IRAs to reservists called to active duty are exempt from the 10% penalty under the following circumstances.

- The reservist was ordered or called to active duty for a period in excess of 179 days or for an indefinite period.
- The distribution must be made during the period **beginning** on the date of such order or call and **ending** at the close of the active duty period.

The amount distributed may be repaid into an IRA. Such repayment is in addition to the dollar limitations for IRA contributions in effect for the year but is not deductible. The repayment must be made within the 2-year period beginning on the day after the end of the active duty period.

IRA: ✔ QP: ✗ RETURNED IRA CONTRIBUTIONS EXCEPTION[64]

Taxpayers that make IRA contributions during a tax year can withdraw them tax-free by the extended due date of the return. Such withdrawn contributions are not subject to the 10% penalty. Contributions that are withdrawn are not deductible.

IRA: ✗ QP: ✗ Earnings on Returned Contributions

Any net income earned on the returned IRA contribution must also be withdrawn. This income is taxable in the year the contribution was made. However, the income is subject to the 10% penalty.[65]

IRA: ✔ QP: ✔ ROLLOVERS EXCEPTION[66]

Taxpayers may transfer funds from one qualified retirement account to another without including the distribution in income. There are two methods of transferring the funds.

1. Direct trustee-to-trustee transfers[67]
2. Distributions to the taxpayer who deposits funds into a qualified plan or IRA within 60 days of receipt

Taxpayers who use the distribution method must be careful to meet the 60-day requirement and only deposit the funds into qualified accounts. Any portion of the distribution not timely deposited must be included in income and may be subject to the 10% penalty, if applicable.

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63. IRC §72(t)(2)(G).

64. IRC §408(d)(4).

65. IRS Pub. 590-A, *Contributions to Individual Retirement Arrangements (IRAs).*

66. IRC §§402(c), 402A(d)(3), 403(a)(4), 403(b)(8), 408(d)(3), and 408A(d)(3).

67. Technically, a direct trustee-to-trustee transfer is not considered a rollover according to Rev. Rul. 78-406, 1978-2 CB 157. However, because this point is not well known and in common vernacular such transfers are referred to as rollovers, this method is included under this topic for clarity purposes.

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Example 17. Ruthanne, age 45, received a $60,000 distribution from her 401(k) plan. The plan administrator withheld $6,000 for federal income taxes and mailed her a check for $54,000. Ruthanne immediately took the check to her local credit union and deposited it into an IRA.

Ruthanne received a Form 1099-R from the 401(k) plan administrator showing $60,000 distributed, $60,000 taxable, and $6,000 in federal income tax withheld. The distribution was coded as an early distribution.

Because only $54,000 was deposited into a qualified account, only $54,000 of the distribution met the rollover requirements. Accordingly, $6,000 of the distribution was taxable and subject to the 10% penalty.

60-Day Requirement

Generally, a taxpayer has 60 days from the date they receive a distribution from an IRA or retirement plan to roll it over to another plan or IRA. If the taxpayer fails to roll over the funds within this period, the distribution is taxable and subject to the 10% penalty, if applicable.

In certain circumstances, **the IRS may waive the 60-day requirement.** There are three methods of having the 60-day requirement waived.[68]

1. **Application of an automatic waiver.** This is only available if the funds were received by a financial institution within the 60-day window but were **not deposited** into a plan or IRA within 60 days solely because of an error on the part of the financial institution.

2. **Request and receive a letter ruling.** Procedures for filing a request are found in Rev. Proc. 2003-16, 2003-1 CB 359 and Rev. Proc. 2019-4, 2019-1 IRB 146.

3. **Qualifying for and using the self-certification procedure.** Under this method, the taxpayer submits a letter to the financial institution that receives the late rollover contribution certifying that they qualify for the rollover for one of the following reasons.[69]

   a. An error was committed by the financial institution receiving the contribution or making the distribution.

   b. The distribution was in the form of a check, which was misplaced and never cashed.

   c. The distribution was deposited into and remained in an account that the taxpayer mistakenly thought was an eligible retirement plan or IRA.

   d. The taxpayer's principal residence was severely damaged.

   e. A member of the taxpayer's family died.

   f. The taxpayer or a member of the taxpayer's family was seriously ill.

   g. The taxpayer was incarcerated.

   h. Restrictions were imposed by a foreign country.

   i. A postal error occurred.

   j. The distribution was made on account of a levy under IRC §6331 and the proceeds of the levy have been returned to the taxpayer.

   k. The party making the distribution to which the rollover relates delayed providing information that the receiving plan or IRA required to complete the rollover despite the taxpayer's reasonable efforts to obtain the information.

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68. *Retirement Plans FAQs relating to Waivers of the 60-Day Rollover Requirement.* Dec. 4, 2019. IRS. [www.irs.gov/retirement-plans/retirement-plans-faqs-relating-to-waivers-of-the-60-day-rollover-requirement] Accessed on Dec. 21, 2019.

69. Rev. Proc. 2016-47, 2016-37 IRB 346.

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The contribution must be made to the plan or IRA as soon as practicable after the reason or reasons listed above no longer prevent the taxpayer from making the contribution. This requirement is deemed to be satisfied if the contribution is made within 30 days after the reason or reasons no longer prevent the taxpayer from making the contribution.

Note. Rev. Proc. 2016-47 provides a sample letter to use to certify the late rollover.

Once-Per-Year IRA Rollover Rule[70]

An individual may only make one rollover from an IRA to another IRA in any **12-month period**. The once-per-year IRA rollover rule applies by aggregating all of the individual's IRAs, including SEP IRAs, SIMPLE IRAs, traditional IRAs, and Roth IRAs, effectively treating them as one IRA for purposes of the limit.[71] Violating the 12-month rule can have serious consequences.

1. The distribution must be included in income and is subject to the 10% penalty, if applicable.
2. The portion of the distribution rolled over may be treated as an excess IRA contribution.
3. Excess contributions remaining in the IRA are subject to the 6% excess contributions tax.

Note. As explained by the Tax Court in *Bobrow v. Comm'r,*[72] the purpose of this restriction is to prevent taxpayers from repeatedly shifting nontaxable income in and out of retirement accounts.

This rule does not apply to the following types of rollovers.[73]

- Traditional IRA to Roth IRA conversions
- Direct trustee-to-trustee transfers
- Transfers to or from a qualified plan

Spousal Rollovers

In general, distributions from an eligible plan or IRA paid to a taxpayer's spouse after the taxpayer's death are treated as if the spouse were the taxpayer.[74] Accordingly, surviving spouses may roll over distributions from these plans into plans in their own names without paying taxes or penalties on the distributions.

Caution. The Form 1099-R issued for a distribution from the account of the deceased taxpayer may **not** indicate that the funds were transferred to an account in the name of the surviving spouse even in the case of a direct trustee-to-trustee transfer.

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70. IRC §408(d)(3)(B).

71. *IRA One-Rollover-Per-Year Rule.* Jan. 9, 2020. IRS. [www.irs.gov/retirement-plans/ira-one-rollover-per-year-rule] Accessed on Jan. 13, 2020.

72. *Bobrow v. Comm'r,* TC Memo 2014-21 (Jan. 28, 2014).

73. IRS Announcement 2014-32, 2014-48 IRB 907.

74. IRC §§402(c)(9) and 408(d)(3)(C).

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Spousal Rollovers and IRS Letter Rulings. There are two IRS letter rulings regarding rolling over distributions from inherited IRAs by surviving spouses. Both letter rulings relate to IRA accounts that named trusts as the beneficiaries of the accounts. Accordingly, **neither** letter ruling should be used to interpret situations in which the **surviving spouse is the designated beneficiary.**

In Ltr. Rul. 9234032, the IRS agreed to the taxpayer's request to disregard the grantor trust that was named as beneficiary of the account. This allowed the surviving spouse to treat the distributions as if she received them directly and roll them over into her own IRA.

In Ltr. Rul. 201707001, the IRS recognized the taxpayer's request to treat the accounts left to the trust as her own pursuant to Treas. Reg. §1.408-8, Q&A-5. However, it also ruled that the once-per-year limitation applied to the surviving spouse who requested the ruling.

> **Note.** It is important to remember that letter rulings are binding only with respect to the taxpayer who requested the ruling and are not substantial authority. They are, however, useful in understanding how the IRS might interpret the law given a certain set of facts.

IRA: ✗ QP: ✔ SEPARATION FROM SERVICE EXCEPTION[75]

If an employee separates from service during or after the year the employee reaches age 55, the distribution is not subject to the 10% penalty. If the employee is a qualified public safety employee in a governmental defined benefit plan, the exception applies when the employee is age 50 or over.

In general, public safety employees are police, firefighters, and emergency medical providers. Effective for distributions after December 31, 2015, the exception for public safety employees is expanded from employees of state and local governmental units to include specified federal law enforcement officers, customs and border protection officers, federal firefighters, and air traffic controllers. In addition, the restriction that only defined benefit plans qualify for the exemption is eliminated.

Practitioner Planning Tip

There are more exceptions to early withdrawal penalties available to IRAs than to other types of plans. Taxpayers contemplating early withdrawals may be well advised to consider a rollover from a qualified plan to a traditional IRA before taking a withdrawal.

[75] IRC §§72(t)(2)(A)(v) and 72(t)(10).

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PENALTY EXCEPTIONS SUMMARY[76]

Circumstance	Exception to 10% Withdrawal Penalty? Qualified Plans (401(k), etc.)	IRA, SEP, SIMPLE IRA,[a] and SARSEP Plans	IRC Sections
Age After participant/IRA owner reaches age 59½	Yes	Yes	§72(t)(2)(A)(i)
Automatic enrollment Permissive withdrawals from a plan with auto enrollment features	Yes	Yes[b]	§414(w)(1)(B)
Birth or adoption of a child[77] $5,000 maximum within one year of birth or adoption (effective after December 31, 2019)	Yes	Yes	§72(t)(2)(H)
Corrective distributions Corrective distributions (and associated earnings) of excess contributions, excess aggregate contributions, and excess deferrals, made timely	Yes	N/A	§§401(k)(8)(D), 401(m)(7)(A), 402(g)(2)(C)
Death After death of the participant/IRA owner	Yes	Yes	§72(t)(2)(A)(ii)
Disability Total and permanent disability of the participant/IRA owner	Yes	Yes	§72(t)(2)(A)(iii)
Disasters $100,000 maximum for qualified disaster distributions	Yes	Yes	PL 116-94, Div. Q, §§201–205
Domestic relations To an alternate payee under a qualified domestic relations order	Yes	N/A	§72(t)(2)(C)

[a] SIMPLE IRA distributions incur a 25% additional tax instead of 10% if made within the first two years of participation

[b] SIMPLE IRAs and SARSEPs only, not for other IRAs.

76. *Retirement Topics — Exceptions to Tax on Early Distributions.* Oct. 29, 2019. IRS. [www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-tax-on-early-distributions] Accessed on Dec. 16, 2019.

77. SECURE Act §113.

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Circumstance	Exception to 10% Withdrawal Penalty? Qualified Plans (401(k), etc.)	IRA, SEP, SIMPLE IRA,[a] and SARSEP Plans	IRC Sections
Education			
Qualified higher education expenses	No	Yes	§72(t)(2)(E)
Equal payments			
Series of substantially equal payments	Yes	Yes	§72(t)(2)(A)(iv)
Employee Stock Ownership Plan (ESOP)			
Dividend pass-through from an ESOP	Yes	N/A	§72(t)(2)(A)(vi)
Homebuyers			
Qualified first-time homebuyers, up to $10,000	No	Yes	§72(t)(2)(F)
Levy			
Because of an IRS levy of the plan	Yes	Yes	§72(t)(2)(A)(vii)
Medical			
Amount of unreimbursed medical expenses (>7.5% adjusted gross income (AGI))	Yes	Yes	§72(t)(2)(B)
Health insurance premiums paid while unemployed	No	Yes	§72(t)(2)(D)
Military			
Certain distributions to qualified military reservists called to active duty	Yes	Yes	§72(t)(2)(G)
Returned IRA contributions			
If withdrawn by extended due date of return	N/A	Yes	§408(d)(4)
Earnings on returned contributions	N/A	No	§408(d)(4)
Rollovers			
In-plan Roth rollovers or eligible distributions contributed to another retirement plan or IRA within 60 days	Yes	Yes	§§402(c), 402A(d)(3), 403(a)(4), 403(b)(8), 408(d)(3), 408A(d)(3)
Separation from service			
Employee separates from service during or after the year the employee reaches age 55[c]	Yes	No	§§72(t)(2)(A)(v), 72(t)(10)
Public safety employees of a state, or political subdivision of a state, in a governmental defined benefit plan, separating from service at or after age 50	Yes	No	§§72(t)(2)(A)(v), 72(t)(10)

[a] SIMPLE IRA distributions incur a 25% additional tax instead of 10% if made within the first two years of participation.

[b] SIMPLE IRAs and SARSEPs only, not for other IRAs.

[c] Effective for distributions after December 31, 2015, the exception for public safety employees who are age 50 or over is expanded to include specified federal law enforcement officers, customs and border protection officers, federal firefighters, and air traffic controllers. Also, the restriction that only defined benefit plans qualify for the exemption is eliminated. Thus, an exemption is allowed for distributions from defined contribution plans or other types of governmental plans, such as the Thrift Savings Plan. See IRC §72(t)(10), as amended by the Defending Public Safety Employees' Retirement Act, PL 114-26.

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Caution. Form 1099-R is used to report retirement distributions. Even if the form indicates that the distribution was made before the recipient reached age 59½, (box 7, code 1), the taxpayer may qualify for one of the additional exceptions. Practitioners are advised to review the additional exceptions with their clients to determine if any apply.

LOANS FROM RETIREMENT PLANS[78]

Loans are only permitted from qualified plans, §403 annuity plans, and governmental plans. IRAs, SEPs, SARSEPs, and SIMPLE IRAs do not qualify for this purpose.

Employees may take loans from their qualified employer retirement plans without the loans being treated as distributions if the following requirements are met.[79]

1. The loan is made subject to a legally enforceable agreement.
2. The loan does not exceed the lesser of:
   a. The greater of $10,000 or 50% of the vested account balance, or
   b. $50,000.

Note. Under the CARES Act, the loan cannot exceed the lesser of:

1. The greater of $10,000 or **100%** of the vested account balance, or
2. **$100,000.**

The increased limit in the loan amount is effective for loans made during the 180-day period beginning on the day the CARES Act was enacted (i.e., March 27, 2020, through September 23, 2020).[80]

3. The loan must generally be repaid within five years.

Note. The CARES Act makes some changes to the rules for repayment of loans from retirement plans. Any due date for a repayment of a loan from a retirement plan that occurs between March 27, 2020, and December 31, 2020, is delayed for one year. Any subsequent repayments and any interest accrued will be appropriately adjusted to reflect the delayed due date. The changes to the repayment schedule extend the 5-year period for repayment.[81]

4. Payments are made at least quarterly in substantially level amounts.

A deemed distribution occurs at any time that these requirements are not satisfied. The amount of the deemed distribution is equal to the balance of the loan including interest due at the time of the failure.[82]

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78. *Retirement Plans FAQs regarding Loans.* Dec. 21, 2019. IRS. [www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-loans] Accessed on Dec. 27, 2019.

79. IRC §72(p)(2); Treas. Reg. §1.72(p)-1.

80. PL 116-136, §2202(b).

81. PL 116-136, §2202(b)(2).

82. Treas. Reg. §1.72(p)-1, Q&A-10.

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The employer's plan administrator is responsible for designing the loan agreement within the parameters of these requirements to ensure that the initial loan is qualified. Problems arise when the loan payments are not made in accordance with the loan provisions.[83]

If the plan provides participants with an opportunity to catch up on the missed payments within a certain period of time ("the cure period"), the participant has until the end of the cure period to rectify the situation and avoid a deemed distribution.[84] The deemed distribution date is generally the date that the cure period expired.[85]

Example 18. Louella received a $40,000 loan from her employer's 401(k) plan just prior to taking a leave of absence from her employer. The loan repayments were supposed to be taken from her wages during her leave, but they were not.

She was informed of the failure to make the payments when she returned from her leave. By the time she knew of the problem, the cure period had expired.

Although she attempted to rectify the problem by making catch-up payments, the Tax Court ruled that the payments made after the cure period did not prevent the loan from being in default, and, accordingly, the loan balance was properly treated as a deemed distribution.[86]

Note. This example is based on *Frias v. Comm'r.* For more information about the case, see the 2018 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 4: Rulings and Cases. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Although it is not addressed in the case, Ms. Frias' tax basis in her retirement plan should have been increased by the amount of the repayments she made on the loan after the deemed distribution.[87]

In addition to any cure period permitted under the terms of the qualified retirement plan, the Code permits taxpayers time to "roll over" a loan offset in certain circumstances. The loan rollover provisions only apply in the following situations.[88]

1. The loan amount was deemed distributed because the plan was terminated.
2. The taxpayer separated from employment, causing them to fail to meet the repayment terms.

Taxpayers have until the due date (including extensions) for filing the federal return for the tax year in which the loan offset occurs to roll over the deemed distribution into an eligible plan.

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83. Treas. Reg. §1.72(p)-1, Q&A-4(a); *Duncan v. Comm'r*, TC Memo 2005-171 (Jul. 12, 2005); *Molina v. Comm'r*, TC Memo 2004-258 (Nov. 10, 2004).

84. Treas. Reg. §1.72(p)-1, Q&A-10(a); *Owusu v. Comm'r,* TC Memo 2010-186 (Aug. 23, 2010).

85. The distribution date is deemed to be December 31 of the year of the disqualifying act if the cure period extends beyond the end of the calendar year. Treas. Reg. §1.72(p)-1, Q&A 10.

86. This example is taken from the facts and conclusions in *Frias v. Comm'r,* TC Memo 2017-139 (Jul. 11, 2017).

87. Treas. Reg. §1.72(p)-1, Q&A 21.

88. IRC §402(c)(3)(C).

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PLAN LOAN REPAYMENT EXCEPTIONS[89]

As discussed earlier, qualified loans are not treated as distributions if the terms require that the loan be repaid within five years in substantially equal payments at least quarterly. However, there are a few exceptions to these requirements.

1. A loan that is taken for the purpose of purchasing the employee's principal residence may be paid back over a period of more than five years.[90]
2. A plan may suspend loan repayments for employees performing military service.[91]
3. A plan may suspend loan repayments during a leave of absence of up to one year. However, upon return, the participant must make up the missed payments either by increasing the amount of each monthly payment or by paying a lump sum at the end, so that the term of the loan does not exceed the original 5-year term.[92]

REQUIRED MINIMUM DISTRIBUTIONS (RMDs)

REQUIRED BEGINNING DATE

In an attempt to ensure that individuals spend their retirement savings during their lifetime and do not use their retirement accounts for estate planning purposes to transfer wealth to beneficiaries, Congress created a requirement that retirement plan participants begin taking minimum distributions at age 70½.[93] **The SECURE Act of 2019 increased the age to 72** for individuals to begin RMDs.[94] The change applies to individuals who attain age 70½ after December 31, 2019 (i.e., individuals born **after** June 30, 1949[95]). Accordingly, individuals who were required to take RMDs prior to December 31, 2019, must continue to take RMDs even if they have not yet reached age 72.

However, the CARES Act suspends RMDs for the calendar year 2020. The temporary waiver of RMDs applies to:[96]

1. A defined contribution plan described in IRC §§401(a), 403(a), or 403(b);
2. A defined contribution plan that is an eligible deferred compensation plan described in IRC §457(b) but only if the plan is maintained by a state, political subdivision of a state, and any agency or instrumentality of a state or political subdivision of a state; or
3. An individual retirement plan.

Taxpayers who did not take their first RMD for 2019 by April 1, 2020, are not required to take their RMD for either 2019 or 2020.[97]

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89. *Retirement Plans FAQs regarding Loans.* Dec. 21, 2019. IRS. [www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-loans] Accessed on Dec. 27, 2019.
90. IRC §72(p)(2)(B)(ii); Treas. Reg. §1.72(p)-1, Q&A-5,-6, -7, and -8.
91. Treas. Reg. §1.72(p)-1, Q&A-9(b).
92. Treas. Reg. §1.72(p)-1, Q&A-9(a).
93. *The Setting Every Community Up for Retirement Enhancement Act of 2019 (The SECURE Act)*. House Committee on Ways and Means. [waysandmeans.house.gov/sites/democrats.waysandmeans.house.gov/files/documents/SECURE%20Act%20section%20by%20section.pdf] Accessed on Jan. 3, 2020.
94. SECURE Act §114.
95. See Treas. Reg. §1.401(a)(9)-2, Q&A 3.
96. PL 116-136, §2203.
97. Ibid.

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Any RMDs that are required to be distributed within five years do not take the calendar year 2020 into consideration for purposes of determining the 5-year period.[98]

Note. This likely includes distributions of inherited IRAs. Although inherited IRAs are not specifically identified in the legislation, the CARES Act covers RMDs from **any** individual account retirement plan.[99]

Caution. For a taxpayer who took an RMD from an IRA or qualified plan before the enactment of the CARES Act, IRS Notice 2020-23 allowed the taxpayer to roll the distribution over to another plan if they did so by July 15, 2020. Practitioners are advised to question clients who receive a 2020 Form 1099-R to determine if they received an RMD that was rolled over before the deadline.

Practitioner Planning Tip

A taxpayer who took an RMD prior to the enactment of the CARES Act could potentially treat the RMD as a coronavirus-related distribution. The taxpayer must meet one of the previously mentioned coronavirus-related conditions. This would allow the taxpayer to repay the amount over a 3-year period. In addition, the taxpayer can recognize the amount distributed over a 3-year period or entirely in 2020.

RMD provisions do not apply to Roth IRAs while the owner is alive.[100] However, the RMD provisions do apply to amounts held in other types of Roth accounts, such as Roth 401(k) plans.[101]

Note. IRC §401(a)(9) sets forth the basic rules for RMDs from defined contribution plans. Treas. Reg. §1.408-8 provides that the distribution rules of §401(a)(9) apply to IRAs, SEPS, and SIMPLE IRAs. Accordingly, footnotes in this portion of the chapter refer to Code sections that appear to only apply to employer plans.

RMD WITHDRAWALS

Dates

Taxpayers have until April 1 of the year after the year they turn 72 to begin taking RMDs.[102] After the first year, the taxpayer must take the RMD by December 31 of that year.

Example 19. Dottie turns 72 on December 25, 2021. She must take her first RMD (for the year 2021) by April 1, 2022. She must also take her 2022 distribution by December 31, 2022.

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98. Ibid.
99. IRC §401(a)(9)(I), as amended by the CARES Act.
100. IRC §408A(c)(4).
101. IRC §401(a)(9); Treas. Reg. §1.401(a)(9)-1.
102. IRC §401(a)(9)(C)(i).

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RMDs from qualified employer retirement plans may be postponed until the taxpayer retires.[103] Taxpayers who own at least 5% of the company sponsoring the retirement plan do not qualify for this exception.[104]

Combining RMDs

An IRA owner must calculate the RMD separately for each IRA that they own. However, they can withdraw the total amount of their combined RMDs from one or more of the IRAs.[105]

PENALTY FOR FAILING TO TAKE RMDs[106]

If distributions are less than the RMD, the taxpayer may have to pay a 50% excise tax for that year on the amount not distributed as required.

If the excess accumulation is due to reasonable error and the taxpayer has taken, or is taking, steps to remedy the insufficient distribution, they can request that the tax be waived. The request is made by filing Form 5329 and attaching an explanation with the return.

> **Note.** Explaining the taxpayer's age, medical condition, and the steps taken to remedy the situation is nearly always sufficient to have the IRS waive the excess accumulation penalty on failure to take RMDs.

CALCULATING RMDs FOR ORIGINAL IRA OWNERS[107]

> **Note.** RMDs for qualified plans are usually calculated by the plan administrator. Therefore, this material only covers calculating RMDs from IRAs and related plans. For information on calculating RMDs for **individual retirement annuities**, see Treas. Reg. §1.401(a)(9)-6.

> **Note.** This section covers calculating the RMD for the original owner of IRAs. Calculating the RMD for inherited IRAs is covered later.

The RMD is calculated by dividing the IRA account balance on December 31 of the preceding year by the amount from the applicable table. For example, the 2020 RMD is calculated based on the December 31, 2019 balance in the taxpayer's IRA.

The tables showing distribution periods and life expectancies are found in appendix B of IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements (IRAs).*[108] The proper table to use is determined based on the beneficiary of the account. Accordingly, taxpayers must determine the amount of the RMD for each IRA account or group of IRAs with similar beneficiaries.

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103. IRC §401(a)(9)(C)(i)(II).

104. IRC §401(a)(9)(C)(ii).

105. IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements (IRAs).*

106. Ibid.

107. Ibid.

108. On November 8, 2019, the IRS published revised life expectancy tables as part of proposed amendments to the Treasury Regulations used to calculate RMDs. (Treas. Reg. §§1.401(a)(9)-5, -6, -8, and -9). NPRM Reg-132210-18. The proposed tables, if adopted, will apply for distribution calendar years beginning on or after January 1, 2021. The proposed regulations also include transition rules for persons who die before January 1, 2021.

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Life Expectancy Tables

There are three life expectancy tables in IRS Pub. 590-B.

- **Table I, Single Life Table,** is used for IRAs whose owners died before January 1, 2020. This is covered later in the chapter.

Note. At the time this material was published, the changes to required distribution periods implemented by the SECURE Act were not reflected in IRS Pub. 590-B. It is anticipated that the publication will be updated later to incorporate the recent legislation.

- **Table II, Joint and Last Survivor Table,** is used **only** for accounts whose owners are married to spouses more than 10 years younger than they are **and** the spouse is the sole beneficiary of the IRA. The distribution period is the number at the intersection of the taxpayer's and spouse's ages in the table. (See IRS Pub. 590-B for situations involving a change of marital status during the year.)
- **Table III, Uniform Lifetime Table,** is used for all other IRA accounts.

When using Tables II and III, the taxpayer's and spouse's ages to use are their age on their birthdays in the year of the distribution.

Example 20. Richard owns three IRAs with different beneficiaries. Each IRA has a different custodian. In 2020, Richard will be 80 years old and his wife, Jean, will be 60 years old. The applicable beneficiaries and the appropriate life expectancy table are listed for each of his accounts in the following table.

Custodian	Beneficiary(ies)	Table
Fidelity	His children	III
Vanguard	His wife	II
Edward Jones	His wife and children	III

Richard calculates his RMD for each account using the factor from the appropriate table. His total RMD is calculated as follows.

Custodian	12/31/19 Balance	Table	Life Expectancy Factor	RMD
Fidelity	$20,000	III	18.7	$1,070
Vanguard	30,000	II	25.9	1,158
Edward Jones	40,000	III	18.7	2,139
Total combined RMD				$4,367

Although Richard's calculated RMD is $4,367, he withdraws $5,000 from his Vanguard IRA in 2020. He has taken his RMD for the year.

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Table II (continued) (Joint Life and Last Survivor Expectancy) (For Use by Owners Whose Spouses Are More Than 10 Years Younger and Are the Sole Beneficiaries of Their IRAs)										
Ages	**60**	**61**	**62**	**63**	**64**	**65**	**66**	**67**	**68**	**69**
76	26.3	25.6	24.8	24.1	23.4	22.7	22.0	21.4	20.8	20.2
77	26.2	25.4	24.7	23.9	23.2	22.5	21.8	21.2	20.6	19.9
78	26.1	25.3	24.6	23.8	23.1	22.4	21.7	21.0	20.3	19.7
79	26.0	25.2	24.4	23.7	22.9	22.2	21.5	20.8	20.1	19.5
80	25.9	25.1	24.3	23.6	22.8	22.1	21.3	20.6	20.0	19.3
81	25.8	25.0	24.2	23.4	22.7	21.9	21.2	20.5	19.8	19.1
82	25.8	24.9	24.1	23.4	22.6	21.8	21.1	20.4	19.7	19.0
83	25.7	24.9	24.1	23.3	22.5	21.7	21.0	20.2	19.5	18.8
[illegible]	25.6	24.8	24.0	23.2	22.4	21.6	20.9	20.1	[illegible]	18.7

Table III
(Uniform Lifetime)

(For Use by:
- **Unmarried Owners,**
- **Married Owners Whose Spouses aren't More Than 10 Years Younger, and**
- **Married Owners Whose Spouses aren't the Sole Beneficiaries of Their IRAs)**

Age	Distribution Period	Age	Distribution Period
70	27.4	93	9.6
71	26.5	94	9.1
72	25.6	95	8.6
73	24.7	96	8.1
74	23.8	97	7.6
75	22.9	98	7.1
76	22.0	99	6.7
77	21.2	100	6.3
78	20.3	101	5.9
79	19.5	102	5.5
80	18.7	103	5.2
81	17.9	104	4.9

Adjustments to the Yearend IRA Balance[109]

Contributions increase the account balance **in the year** they are made. If a contribution for the prior year is made after December 31 of that year, it is disregarded when calculating the RMD for the current year.

The IRA account balance is adjusted by outstanding rollovers that are not in **any** account at the end of the preceding year. For a rollover from a qualified plan or another IRA that was not in any account at the end of the preceding year, the account balance of the receiving IRA is increased by the rollover amount valued as of the date of receipt.

Distributions reduce the account balance in the year they are made. Distributions made after December 31 of the previous year are disregarded in determining the RMD for the current year.

109. IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements (IRAs).*

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DISTRIBUTIONS IN THE YEAR OF THE OWNER'S DEATH[110]

The RMD for the year of the owner's death depends on whether the owner died before the RMD required beginning date or after. If the owner died before the required beginning date, there is no RMD in the year of the owner's death.

If the owner died on or after the required beginning date, the IRA beneficiaries are responsible for calculating and distributing the owner's RMD in the year of death. The owner's RMD for the year of death is generally based on Table III. However, if the sole beneficiary of the IRA is the owner's spouse who is more than 10 years younger than the owner, Table II should be used. The RMD is not prorated.

DEATH AND RETIREMENT PLAN RMDs

BENEFICIARIES UNDER THE SECURE ACT

The SECURE Act modified the RMD rules for employer plans and IRAs upon the death of an account owner.[111] **These amendments apply to accounts of decedents who died after December 31, 2019.[112]** Generally, distributions must begin by December 31 of the year following the year of death.[113]

For IRAs whose owners died before December 31, 2019, Table 1 of IRS Pub. 590-B is used to calculate the RMD for the beneficiaries. The appropriate age to use is based on the whether the beneficiary is the spouse, another individual, or an entity. See IRS Pub. 590-B for further information.

For IRAs whose owners died after December 31, 2019, Table 1 is used only by **eligible designated beneficiaries**, a new category of beneficiaries. The Code now recognizes three categories of beneficiaries for RMD purposes, and the distribution period is dictated by the class.[114]

1. **Designated beneficiary** — any individual specified as a beneficiary by the deceased in the documentation maintained by the fiduciary of the account

Note. Treas. Reg. §1.401(a)(9)-4, enacted prior to this change, covers designated beneficiaries and related rules.

2. **Eligible designated beneficiary** — spouses and certain other tax-preferred recipients named by the deceased to inherit their interest in the account (This is defined in more detail later.)
3. **Not a designated beneficiary** — someone who succeeds to the decedent's interest without having been identified as the recipient in the proper manner by the decedent or a named beneficiary who is not an individual (such as an estate)

If the beneficiary is **not a designated beneficiary**, the entire remaining interest must be distributed by December 31 of the year containing the fifth anniversary of the owner's death **(the 5-year rule).[115]** However, if the deceased was required to take RMDs before their death, the account must be distributed at least as rapidly as the owner would have depleted the account under the RMD method they were using to determine distributions at the time of their death.[116]

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110. Ibid.
111. SECURE Act §401.
112. SECURE Act §401(a)(3).
113. IRC §401(a)(9)(B)(iii).
114. See IRC §401(a)(9)(E).
115. IRC §401(a)(9)(B)(ii).
116. IRC §401(a)(9(B)(i).

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Practitioner Planning Tip

If the beneficiaries of a person's estate want to stretch their inherited IRA distributions to the maximum limit, the person should make sure that they fill out the paperwork to name beneficiaries. In addition, they should **not** name their estate as the beneficiary to their IRAs.

If the beneficiary is a **designated beneficiary**, but **not** an eligible designated beneficiary, the remaining balance must be distributed within 10 years (the 10-year rule). This applies **regardless** of whether the deceased had already begun taking distributions.[117] However, if the deceased was required to take RMDs, the account must be distributed at least as rapidly as the owner would have depleted the account under the RMD method they were using to determine distributions at the time of their death.[118]

Example 21. Susie (age 25) is the designated beneficiary of her grandmother's IRA. Emma, her grandmother, was 96 years old when she died. Emma's RMD has a factor of 8.1 based upon the Uniform Lifetime table. Susie must deplete the account within 8.1 years (not 10 years).

Only **eligible designated beneficiaries** are allowed to take the distributions over their life expectancy.[119] To use this option, they must begin distributions within one year of the IRA account holder's death.[120] If the eligible designated beneficiary dies before the account is depleted, any remaining balance must be distributed within 10 years of their death.[121]

If a trust is named as the beneficiary to the IRA, the terms of the trust and the status of the trust beneficiaries determine the RMD applicable to the inherited IRA. Rules related to trusts are discussed later in the chapter.

Note. Retirement accounts distributed over long periods as part of estate planning strategies are referred to as **stretch IRAs**. The changes made by the SECURE Act are intended to limit the period allowed for this purpose.

Practitioner Planning Tip

Because of the limits to the stretch IRA provisions implemented by the SECURE Act, tax professionals may wish to discuss other options available to beneficiaries such as Roth conversions or contributions to charitable remainder trusts.

117. IRC §401(a)(9)(H)(i).
118. IRC §401(a)(9(B)(i).
119. IRC §401(a)(9)(H)(ii).
120. IRC §401(a)(9(B)(iii).
121. IRC §401(a)(9)(H)(iii).

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Definition of Designated Beneficiary[122]

A designated beneficiary must be named by the account owner specifically or by the terms of the employer plan.[123] Such beneficiaries do not have to be designated by name if the individuals are identifiable by class. For example, if a person names "my spouse" as the beneficiary, their spouse at the time of their death is identifiable and as such is a designated beneficiary.

The members of a class of beneficiaries "capable of expansion or contraction" are treated as being identifiable if it is possible to identify the class member with the shortest life expectancy. Accordingly, if a person names "my children" as their beneficiary on the account and it is possible to determine who the oldest child is, the beneficiaries are treated as designated beneficiaries.

The regulations specifically state that being named in a will or inheriting under state laws is not sufficient for a beneficiary to be considered designated. Thus, if a person names their estate as the beneficiary of their account, the beneficiaries of the estate are not treated as designated beneficiaries.

Definition of Eligible Designated Beneficiary[124]

An **eligible** designated beneficiary must be one of the following types of people as of the date the account owner dies.

1. The surviving spouse of the deceased
2. A minor child of the deceased
3. Disabled[125]
4. Chronically ill
5. A person who is **not more than 10 years younger** than the deceased and who does not qualify under the previous categories

Example 22. Harry is a widower with no children. He has two IRAs. For the first IRA, he names one of his friends, PJ, who is 40 years younger, as the beneficiary. PJ is not disabled or chronically ill. For his second IRA, he names another friend, Kathy, who is five years younger than him, as the beneficiary.

PJ is a **designated beneficiary** and must take the balance of the IRA over a period not to exceed 10 years. Kathy is an **eligible designated beneficiary** and must take the balance over her projected life expectancy starting not later than one year after Harry's death.

Payments to Minor Children. Under the changes made by the SECURE Act, a child of the decedent ceases to be an eligible designated beneficiary as of the date that the child reaches the age of majority. Any remaining funds in the account must be distributed within 10 years after that date.[126]

The Code does not provide a definition of **age of majority** for these purposes. Accordingly, one must look to state law to determine if a child is considered an adult in this situation.[127]

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122. IRC §401(a)(9)(E); Treas. Reg. §1.401(a)(9)-4, Q&A 1.
123. Treas. Reg. §1.401(a)(9)-4, Q&A 1.
124. IRC §401(a)(9)(E)(ii).
125. Within the meaning of IRC §72(m)(7).
126. IRC §401(a)(9)(E)(iii).
127. See, e.g., *Robert and Elaina Ray v. U.S.*, No. 2:12-cv-677 (S.D. Ohio Jan. 6, 2014).

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Example 23. Fredricka listed her child, Charlie, as the beneficiary of her IRA until he reaches the age of majority. At the time Fredricka passed away, Charlie was 14 and lived in Illinois. In Illinois, the age of majority is generally 18. As a minor child, Charlie is an eligible designated beneficiary until he reaches age 18.

Charlie's guardians would like to stretch out the tax consequences of the IRA distributions for the longest period possible. For the first three years, when Charlie is under age 18, he is allowed to take minimum distributions based on his projected life expectancy. When he turns 18, he must deplete the account within 10 years.

Special Rule for Minor Children. These changes were made subject to existing law that provides that any amount paid to a child is treated **as if it had been paid to the surviving spouse** if such amount is payable to the surviving spouse after the child reaches the age of majority.[128] A child may be treated as having **not** reached the age of majority if the child has not completed a specified course of education and is under the age of 26. In addition, a child who is disabled may be treated as under the age of majority as long as the child continues to be disabled. Thus, when payments become payable to the surviving spouse because the child attains the age of majority, recovers from a disabling illness, dies, or completes a specified course of education, there is no increase in benefits.[129]

Example 24. Use the same facts as **Example 23,** except under the term of the governing document, any balance in the IRA goes to Sam (Fredrika's surviving spouse) after Charlie reaches the age of majority. Charlie attends college and graduates when he is 25.

Because Charlie has not reached the age of majority defined in §401(a)(9)(F) until he graduates at age 25, he may continue to receive RMDs based upon his life expectancy. After this event, the IRA distributions belong to Sam.

Definitions of Disabled and Chronically Ill. For these purposes, disability is defined the same way as it is for the exception to the 10% penalty (discussed previously).[130] The definition of **chronic illness** is based on the definition applicable to qualified long-term care insurance.[131] A person is considered chronically ill for these purposes if a licensed healthcare practitioner has certified within the last 12 months that one of the following conditions applies.[132]

1. The person is unable to perform at least two activities of daily living without substantial assistance from another individual due to a loss of functional capacity. The period of inability must be indefinite and reasonably expected to be lengthy in nature. The Code lists six activities of daily living for this purpose: eating, toileting, transferring, bathing, dressing, and continence.
2. The person has a level of disability similar to one described in item 1.
3. The person requires substantial supervision to protect themselves from threats to health and safety due to severe cognitive impairment.

For qualified long-term care insurance purposes, the first requirement must be met for at least 90 days.[133] For RMD purposes, the SECURE Act substitutes "indefinite" and "reasonably expected to be lengthy in nature" for the period of days.[134]

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128. IRC §401(a)(9)(F).
129. Treas. Reg. §1.401(a)(9)-6, Q&A 15.
130. IRC §401(a)(9)(E)(ii)(III).
131. IRC §401(a)(9)(E)(ii)(IV).
132. IRC §§7702B(c)(2) and 401(a)(9)(E)(ii)(IV).
133. IRC §7702B(c)(2).
134. IRC §401(a)(9)(E)(ii)(IV).

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Exceptions to the Effective Date of Changes Made by the SECURE Act[135]

Certain types of plans are not immediately subject to the changes made by the SECURE Act. The following types of plans have various extended effective dates.

1. Employer plans maintained pursuant to collective bargaining agreements
2. Governmental plans under IRC §414(d)
3. Certain existing annuity contracts

If an account owner dies **before** the effective date and their designated beneficiary dies **after** the effective date, the amendments made by the SECURE Act apply to the beneficiaries of the designated beneficiary. The designated beneficiary is treated as an eligible designated beneficiary for purposes of allowing distributions to be taken over the life expectancy of the beneficiary. For this purpose, the effective date means the first day of the first calendar year to which the amendments made apply to a plan with respect to account owners dying on or after such date.

> **Note.** For more information about these extended effective dates, see the SECURE Act §§401(a) and (b).

SPECIAL RULES FOR INHERITED IRAs[136]

IRAs With Basis

If the decedent had a basis in their traditional IRA due to nondeductible contributions, that basis remains with the IRA. The basis cannot be combined with the basis in the recipients' other IRAs, unless the beneficiary is the decedent's spouse and chooses to treat the IRA as their own. Exceptions for surviving spouses are discussed later in the chapter.

Taxpayers who take distributions from inherited IRAs and other IRAs in the same year must file separate Forms 8606, *Nondeductible IRAs*, for each IRA with basis.

Federal Estate Tax Deduction

A beneficiary may be able to claim a deduction for estate tax resulting from distributions from a traditional IRA. The beneficiary can deduct the estate tax **paid** on any part of a distribution that is income in respect of a decedent. They can take the deduction for the tax year the income is reported.

> **Note.** For information on claiming this deduction, see "Estate Tax Deduction" under "Other Tax Information" in IRS Pub. 559, *Survivors, Executors, and Administrators*.

> **Observation.** After passage of the Tax Cuts and Jobs Act (TCJA), the federal estate tax deduction is still permitted because it is not a miscellaneous itemized deduction subject to the 2% of AGI limitation.[137]

Surviving Spouses

Surviving spouses have three options regarding IRA accounts that were held by their deceased spouse.

1. Treat the IRA as their own by designating themselves as the account owner
2. Roll over the balance into an IRA or eligible qualified plan
3. Take the distributions as a beneficiary of the account designated as an inherited IRA

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135. SECURE Act §§401(a)(3) and (4) and 401(b).
136. IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements (IRAs).*
137. IRS Pub. 529, *Miscellaneous Deductions.*

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Treating the IRA as their Own. The option to treat the IRA as the surviving spouse's own only applies if the surviving spouse is the sole beneficiary of the IRA and has an unlimited right to withdraw from it. The surviving spouse is deemed to have chosen this option if they make contributions to the inherited IRA or if they do not take the RMD for any year as a beneficiary of the IRA.

If the decedent had a basis in the IRA and the surviving spouse chose to treat the IRA as their own, they may combine the basis with any basis they have in their own traditional IRA.

If the deceased person was required to take an RMD in the year of their death, that RMD must be satisfied based on the deceased person's situation (as discussed previously). After the year of death, the RMD provisions apply as if the surviving spouse owned the account at the beginning of the year that they became the owner.

Example 25. Glen and Doris both turned 80 in 2019. Glen passed away in December after he had taken his RMD for the year. Doris, his wife, was the sole beneficiary of his IRA. She chooses to treat the IRA as her own. If Doris takes her RMD for 2020, she must include the December 31, 2019 balance of the inherited IRA in her calculation and use her age of 81.

Rolling Over the Balance. Once the balance of an inherited IRA has been transferred into a qualifying account in the surviving spouse's name as the owner and not as a beneficiary, the funds are treated as if they always belonged to the surviving spouse. All rules related to early distributions and RMDs apply as if the funds never belonged to anyone else.

Example 26. Venita was 60 when her husband, Cliff, died at the age of 70 in 2020. She rolled his IRAs into her own. She is not required to begin RMDs of the funds until she reaches age 72 in 2032. However, because she is over age 59½, she may take the funds at any time without incurring the 10% early withdrawal penalty.

Practitioner Planning Tip

If Venita in **Example 26** were younger, she might not want to have the IRA funds in her name. If she left the funds in an inherited IRA, she could take the funds without penalty regardless of her age because Cliff had already met the age requirement.

Taking the Funds as a Spousal Beneficiary. The option to maintain the status of the IRA funds as inherited means the following rules applicable to spousal beneficiaries apply to the account. Note that the spouse may choose to stop taking distributions under the rules for a spousal beneficiary at any time by designating themselves as the owner or rolling the funds over into an account in their name.

1. The date on which the distributions are required to begin is not earlier than the date on which the deceased would have attained age 72.[138]
2. If the deceased person had begun to take their RMDs, the life expectancy that the spouse must use to calculate the RMD is the longer of:
   a. The remaining life expectancy of the surviving spouse, or
   b. The remaining life expectancy of the decedent.[139]
3. If the deceased person had **not** begun to take their RMDs, the RMD is based on the life expectancy of the surviving spouse.[140]

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138. IRC §401(a)(9)(B)(iv).

139. Treas. Reg. §1.401(a)(9)-5, Question 5, A-5(a).

140. Treas. Reg. §1.401(a)(9)-5, Question 5, A-5(b).

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Multiple Beneficiaries

In general, if more than one **individual** is designated as a beneficiary, the balance in the IRA must be distributed based on the beneficiary with the shortest life expectancy. This individual is the designated beneficiary if both of the following apply.[141]

- All account beneficiaries are individuals.
- The account has not been divided into separate accounts for each beneficiary.

Separate Accounts.[142] A single IRA can be split into separate accounts or shares for each beneficiary. These separate accounts or shares can be established at any time, either before or after the owner's required beginning date. Generally, these separate accounts or shares are combined for purposes of determining the RMD. However, these separate accounts or shares are not combined for RMD purposes after the death of the IRA owner if the separate accounts or shares are established by the end of the year following the year of the IRA owner's death.

The separate account rules cannot be used by beneficiaries of a trust (discussed next).

Trusts as Beneficiaries

If a person **other** than an individual is designated as a beneficiary of an IRA account, the account is treated as having no designated beneficiary for purposes of calculating the RMD, even if there are also individuals designated as beneficiaries.[143]

A trust that is named as the beneficiary of an IRA may be disregarded for RMD purposes and the beneficiaries of the trust can be treated as if they were designated beneficiaries **only** if the following requirements are met.[144]

1. The trust is valid under state law.
2. The trust is irrevocable or, by its terms, becomes irrevocable upon the account holder's death.
3. The beneficiaries of the trust are identifiable from the trust instrument.
4. The trust documents or a certified list of trust beneficiaries have been provided to the plan administrator.[145]

If the trust has more than one beneficiary, the separate account rules under Treas. Reg. §1.401(a)(9)-8 are not available to beneficiaries of a trust.[146] Thus, the IRA must be distributed in accordance with the rules for multiple beneficiaries, explained earlier.

The terms of the trust determine if the trust has more than one beneficiary. The regulations provide two examples of trusts with the spouses named as the primary beneficiary and children as remainder beneficiaries.[147] In the first example, under the terms of the trust, only the portion of the IRA distribution received by the trustee equal to the **income earned** by the IRA is required to be distributed to the spouse. Thus, the rules for multiple beneficiaries apply. In the second example, **all IRA distributions** are required to be distributed by the trust to the spouse. This trust is treated as if the spouse is the sole beneficiary of the account for the RMD rules.

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141. IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements (IRAs).*

142. Ibid.

143. Treas. Reg. §1.401(a)(9)-4, Q&A 3.

144. Treas. Reg. §1.401(a)(9)-4, Q&A 5.

145. Treas. Reg. §1.401(a)(9)-4, Q&A 6.

146. Treas. Reg. §1.401(a)(9)-4, Q&A 5.

147. Treas. Reg. §1.401(a)(9)-5, Q&A 7.

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If the beneficiary of the trust is another trust, the beneficiaries of the other trust are treated as being designated as beneficiaries of the first trust. If both trusts meet the above requirements, the RMD rules are applied according to who is the beneficiary of the other trust.[148]

Certain Trusts for Disabled or Chronically Ill Beneficiaries.[149] If a multi-beneficiary trust has at least one beneficiary who is disabled or chronically ill, the RMD rules applicable to such individuals may apply. To qualify, the terms of the trust must divide the trust immediately upon the death of the IRA account holder into separate trusts for each beneficiary unless the only beneficiaries are disabled or chronically ill individuals. If the beneficiary qualifies as disabled or chronically ill, RMD distributions may be taken over their life expectancy as long as the RMDs begin no later than one year after the account holder's death.

ROTH IRAs[150]

Contributions to Roth IRAs are not tax-deductible and qualified distributions are not taxable. Contributions may be made to Roth IRAs regardless of the taxpayer's age provided the taxpayer has earned income. However, taxpayers with income above applicable limits are prohibited from making contributions to Roth IRAs.[151]

> **Note.** This section covers Roth IRA distributions. For more information about Roth IRA contribution rules and the applicable income limits, see IRS Pub. 590-A, *Contributions to Individual Retirement Arrangements (IRAs).*

The RMD rules that apply to traditional IRAs do not apply to Roth IRAs while the owner is alive. However, after the owner dies, the RMD rules applicable to traditional IRAs apply as though the Roth IRA owner died before the date they were required to begin taking RMDs (as discussed earlier).

Distributions from Roth accounts are deemed to be taken first from contributions to the IRA. Recovery of contributions is not included in income regardless of the taxpayer's age or other qualifying situations.

Qualified distributions of income from Roth accounts are not taxable. They are qualified if they are made **after** the 5-year period beginning with the first tax year for which a contribution was made to a Roth IRA in the name of the taxpayer **and** made under one of the following conditions.[152]

1. After the taxpayer reaches age 59½
2. Because the taxpayer is disabled
3. To a beneficiary of the taxpayer after the taxpayer's death
4. For purchase of a first home (up to a $10,000 lifetime limit)

5-YEAR WAITING PERIODS

The 5-year waiting period that begins with the first contribution is different than the 5-year waiting period that applies to conversions and rollovers. The first contribution starts the waiting period for all future contributions. A separate 5-year waiting period applies to each conversion and rollover.

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148. IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements (IRAs).*
149. IRC §§401(a)(9)(H)(iv) and (v).
150. IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements (IRAs).*
151. IRC §408A(c)(3).
152. IRC §408A(d)(2).

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Distributions of Contributions During the 5-Year Waiting Period

Despite the general prohibition of withdrawing Roth IRA funds during the first five years after the first contribution to a Roth IRA, there are no tax consequences to withdrawing ordinary contributions. If the taxpayer also withdraws earnings, the earnings are subject to tax and potentially penalties.

Example 27. Jerry established his first Roth IRA when he was 58 years old. He contributed $5,000. Two years later, when Jerry is 60, he closed the Roth IRA and received a total of $5,500. The first $5,000 of the distribution is a return of his nondeductible contribution, so there is no tax or penalty. The $500 of earnings is subject to income tax, but it is not subject to the 10% early withdrawal penalty because Jerry is over age 59½.

Practitioner Planning Tip

The ability to make withdrawals of ordinary contributions from Roth IRAs provides a taxpayer with the flexibility to fund needs such as early retirement or children's education expenses prior to the date the taxpayer reaches age 59½.

Distributions of Rollovers During the 5-Year Waiting Period

Taxpayers may convert traditional IRAs to Roth IRAs and may roll over funds from qualified retirement plans to Roth IRAs. Such transfers are included in income at the time of the transaction, but they are not subject to the additional 10% penalty. However, if the transfers are withdrawn from the Roth IRAs before the 5-year waiting period expires, the distribution is subject to the 10% penalty for early withdrawal unless another exception applies.

The 5-year waiting period applies to each transfer separately. Under the ordering rules, distributions are made first from contributions, then from conversions and rollovers on a first-in-first-out basis, and then from earnings.

As explained previously, the withdrawal of **contributions** is never subject to the early withdrawal penalty. Distributions of rollovers and transfers from other retirement accounts are only subject to the penalty if made within the 5-year waiting period and none of the early distribution exceptions apply. Early distributions of earnings are only subject to the penalty if none of the exceptions apply.

Example 28. In 2014, when she was 40 years old, Sophie rolled over $20,000 from her 401(k) plan to a new Roth IRA. She reported the $20,000 rollover and paid income taxes on the transfer. Because it was a qualified rollover, she did not pay the 10% early withdrawal penalty. In 2018, she rolled over an additional $10,000 from her 401(k) into the Roth IRA, with the same result.

In 2020, Sophie withdrew $36,000 from her Roth IRA. She did not qualify for any exceptions to the 10% early withdrawal penalty. The tax consequences are as follows.

	Amount	5-Year Period Satisfied	Subject to Income Tax	Subject to 10% Penalty
2014 rollover	$20,000	Yes	No	No
2018 rollover	10,000	No	No	Yes
Earnings	6,000	No	Yes	Yes

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Distributions After Death During the 5-Year Waiting Periods

If a distribution to a beneficiary is made during one of the 5-year waiting periods, it is included in the beneficiary's gross income in the same manner as it would have been included in the owner's income had it been distributed to the IRA owner when they were alive. If there are multiple beneficiaries, the distributions are allocated to contributions, conversions/rollovers, and income pro-ratably. The distributions are not subject to the 10% early withdrawal penalty due to the death exception.

Example 29. Use the same facts as **Example 28,** except instead of taking the distribution in 2020, Sophie passed away and the money was distributed in equal parts to her four beneficiaries. The following table summarizes the tax consequences to each beneficiary.

	25% Amount	5-Year Period Satisfied	Subject to Income Tax	Subject to 10% Penalty
2014 rollover	$5,000	Yes	No	No
2018 rollover	2,500	No	No	No
Earnings	1,500	No [a]	No [a]	No

[a] Distributions are qualified because the Roth IRA's beginning date was 2014 and the taxpayer was deceased. The beginning date for earnings is always the original date a Roth IRA was opened.[153]

RMD AFTER DEATH

If a Roth IRA owner dies, the RMD rules for beneficiaries of inherited IRAs that apply to traditional IRAs also apply to Roth IRAs. However, because there are no minimum distribution requirements before a Roth IRA owner's death, the RMD rules apply as if the owner had not reached the age of mandatory RMDs.

Not Designated Beneficiaries

Beneficiaries that do not qualify as designated beneficiaries or eligible designated beneficiaries must take the balance of the inherited Roth IRAs over a period not to exceed five years. This applies regardless of the deceased taxpayer's age. This rule most commonly applies to estates.

Designated Beneficiaries

Beneficiaries who are designated beneficiaries, but **not eligible** designated beneficiaries, must take the balance of the inherited Roth IRAs over a period not to exceed 10 years.[154] This applies regardless of the deceased taxpayer's age.

Eligible Designated Beneficiaries

Beneficiaries who are eligible designated beneficiaries may take the balance of the inherited IRAs over their projected life expectancy if they begin taking distributions before the end of the calendar year following the year that the account owner died. However, if the sole beneficiary is the deceased person's **spouse**, they can either delay distributions until the decedent would have reached age 72[155] or treat the Roth IRA as their own.

153. IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements,* pp. 28–35 (2019).

154. IRC §401(a)(9)(H)(i).

155. IRC §401(a)(9)(C).

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BACKDOOR ROTHS

The Code contains modified adjusted gross income (MAGI) limitations on contributions to Roth IRAs,[156] but it does not limit conversions and rollovers based on MAGI. This loophole allows individuals to contribute to nondeductible traditional IRAs and then convert the traditional IRA to a Roth IRA. This maneuver, often called a "backdoor Roth," **only works well if the taxpayer does not have any other traditional IRAs because the portion of IRA distributions treated as a return of nondeductible contributions is prorated based on the total balance of the IRAs.**[157] This is demonstrated in the following examples.

> **Note.** The total balance of the IRAs must be modified for amounts distributed and outstanding rollovers. Complete instructions for calculating the nontaxable portion of traditional IRA distributions when the taxpayer has basis are found in the instructions for Form 8606.

Example 30. Joe did not have any traditional or Roth IRAs in 2018. In 2019, his MAGI for the year was $300,000, which was over the applicable Roth IRA contribution limit. Accordingly, he was not permitted to make contributions directly to a Roth IRA.

Joe contributed $6,000 to a traditional IRA for 2019. Because he was covered by a retirement plan with his employer, his MAGI was too high to deduct the traditional IRA contribution. On his 2019 return, he completed Form 8606 to establish a $6,000 basis in his traditional IRA.

Immediately after contributing the $6,000, he converted the traditional IRA to a Roth IRA. The financial institution holding the funds issued a Form 1099-R for 2019 showing that Joe received a $6,000 distribution from his traditional IRA. Joe reported the distribution on his return and included the distribution on Form 8606 to reduce the taxable portion of the $6,000 distribution by his $6,000 basis.

The result was that Joe was able to add $6,000 to a Roth IRA for 2019 without tax consequences despite his income being over the applicable limits.

Example 31. Use the same facts as **Example 30,** except Joe had $76,000 in traditional IRAs as of December 31, 2019, that were funded when his MAGI was low enough that he could make deductible contributions to traditional IRAs. He had no basis in his traditional IRAs at the end of 2018.

When Joe made the 2019 traditional IRA contribution of $6,000, he set up a new traditional IRA for the express purpose of making the backdoor Roth contribution. However, this was ineffectual because the basis created by the 2019 contribution was applied to his aggregated traditional IRAs. Accordingly, $5,561 of the distribution was taxable. The following worksheet from IRS Pub. 590-B was used to calculate the nontaxable portion of the distribution and the remaining basis in Joe's traditional IRAs to be applied against future traditional IRA distributions. Joe's 2019 Form 8606 follows the worksheet.

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156. IRC §408A(c)(3).

157. IRS Notice 87-16, 1987-1 CB 446.

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For Example 31

February 13, 2020

Worksheet 1-1. **Figuring the Taxable Part of Your IRA Distribution**

Keep for Your Records

Use only if you made contributions to a traditional IRA for 2019 that may not be fully deductible and have to figure the taxable part of your 2019 distributions to determine your modified AGI. See *Limit if Covered by Employer Plan* in chapter 1 of Pub. 590-A.

Form 8606 and the related instructions will be needed when using this worksheet.

Note. When used in this worksheet, the term **outstanding rollover** refers to an amount distributed from a traditional IRA as part of a rollover that, as of December 31, 2019, hadn't yet been reinvested in another traditional IRA, but was still eligible to be rolled over tax free.

1. Enter the basis in your traditional IRAs as of December 31, 2018	1.	0
2. Enter the total of all contributions made to your traditional IRAs during 2019 and all contributions made during 2020 that were for 2019, ***whether or not deductible***. Don't include rollover contributions properly rolled over into IRAs. Also, don't include certain returned contributions described in the instructions for line 7, Part I, of Form 8606	2.	6,000
3. Add lines 1 and 2	3.	6,000
4. Enter the value of all your traditional IRAs as of December 31, 2019 (include any outstanding rollovers from traditional IRAs to other traditional IRAs). Subtract any repayments of qualified disaster distributions	4.	76,000
5. Enter the total distributions from traditional IRAs (including amounts converted to Roth IRAs that will be shown on line 16 of Form 8606) received in 2019. (Don't include outstanding rollovers included on line 4 or any rollovers between traditional IRAs completed by December 31, 2019. Also, don't include certain returned contributions described in the instructions for line 7, Part I, of Form 8606.) Do include repayments of qualified disaster distributions	5.	6,000
6. Add lines 4 and 5	6.	82,000
7. Divide line 3 by line 6. Enter the result as a decimal (rounded to at least three places). If the result is 1.000 or more, enter 1.000	7.	.07317
8. Nontaxable portion of the distribution. Multiply line 5 by line 7. Enter the result here and on lines 13 and 17 of Form 8606	8.	439
9. Taxable portion of the distribution (before adjustment for conversions). Subtract line 8 from line 5. Enter the result here and if there are no amounts converted to Roth IRAs, **stop here** and enter the result on line 15a of Form 8606	9.	5,561
10. Enter the amount included on line 9 that is allocable to amounts converted to Roth IRAs by December 31, 2019. (See **Note** at the end of this worksheet.) Enter here and on line 18 of Form 8606	10.	5,561
11. Taxable portion of the distribution (after adjustments for conversions). Subtract line 10 from line 9. Enter the result here and on line 15a of Form 8606	11.	

Note. If the amount on line 5 of this worksheet includes an amount converted to a Roth IRA by December 31, 2019, you must determine the percentage of the distribution allocable to the conversion. To figure the percentage, divide the amount converted (from line 16 of Form 8606) by the total distributions shown on line 5. To figure the amounts to include on line 10 of this worksheet and on line 18, Part II, of Form 8606, multiply line 9 of the worksheet by the percentage you figured.

Note. IRS Pub. 590-B instructs that if line 5 of the preceding worksheet is greater than line 8, lines 6–12 of Form 8606 should not be completed.

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For Example 31

Form **8606** — Department of the Treasury, Internal Revenue Service (99)

Nondeductible IRAs

► Go to *www.irs.gov/Form8606* for instructions and the latest information.

► Attach to 2019 Form 1040, 1040-SR, or 1040-NR.

OMB No. 1545-0074 — **2019** — Attachment Sequence No. **48**

Name. If married, file a separate form for each spouse required to file 2019 Form 8606. See instructions.	Your social security number
Joe Kerr	999-88-7777

Fill in Your Address Only if You Are Filing This Form by Itself and Not With Your Tax Return

Home address (number and street, or P.O. box if mail is not delivered to your home)		Apt. no.
123 Gotham Lane		
City, town or post office, state, and ZIP code. If you have a foreign address, also complete the spaces below (see instructions).		
Cityville, NY 11001		
Foreign country name	Foreign province/state/county	Foreign postal code

Part I **Nondeductible Contributions to Traditional IRAs and Distributions From Traditional, SEP, and SIMPLE IRAs**

Complete this part only if one or more of the following apply.

- You made nondeductible contributions to a traditional IRA for 2019.
- You took distributions from a traditional, SEP, or SIMPLE IRA in 2019 **and** you made nondeductible contributions to a traditional IRA in 2019 or an earlier year. For this purpose, a distribution does not include a rollover (other than a repayment of a qualified disaster distribution (see 2019 Forms 8915-C and 8915-D)), qualified charitable distribution, one-time distribution to fund an HSA, conversion, recharacterization, or return of certain contributions.
- You converted part, but not all, of your traditional, SEP, and SIMPLE IRAs to Roth IRAs in 2019 **and** you made nondeductible contributions to a traditional IRA in 2019 or an earlier year.

Line	Description			Line	Amount
1	Enter your nondeductible contributions to traditional IRAs for 2019, including those made for 2019 from January 1, 2020, through April 15, 2020. See instructions			1	6,000
2	Enter your total basis in traditional IRAs. See instructions			2	0
3	Add lines 1 and 2			3	6,000
	In 2019, did you take a distribution from traditional, SEP, or SIMPLE IRAs, or make a Roth IRA conversion? No ► Enter the amount from line 3 on line 14. Do not complete the rest of Part I. Yes ► Go to line 4.				
4	Enter those contributions included on line 1 that were made from January 1, 2020, through April 15, 2020			4	0
5	Subtract line 4 from line 3			5	6,000
6	Enter the value of **all** your traditional, SEP, and SIMPLE IRAs as of December 31, 2019, plus any outstanding rollovers. Subtract any repayments of qualified disaster distributions (see 2019 Forms 8915-C and 8915-D)	6			
7	Enter your distributions from traditional, SEP, and SIMPLE IRAs in 2019. **Do not** include rollovers (other than repayments of qualified disaster distributions (see 2019 Forms 8915-C and 8915-D)), qualified charitable distributions, a one-time distribution to fund an HSA, conversions to a Roth IRA, certain returned contributions, or recharacterizations of traditional IRA contributions (see instructions)	7			
8	Enter the net amount you converted from traditional, SEP, and SIMPLE IRAs to Roth IRAs in 2019. Also enter this amount on line 16	8			
9	Add lines 6, 7, and 8 (9)				
10	Divide line 5 by line 9. Enter the result as a decimal rounded to at least 3 places. If the result is 1.000 or more, enter “1.000”	10	× .		
11	Multiply line 8 by line 10. This is the nontaxable portion of the amount you converted to Roth IRAs. Also enter this amount on line 17	11			
12	Multiply line 7 by line 10. This is the nontaxable portion of your distributions that you did not convert to a Roth IRA	12			
13	Add lines 11 and 12. This is the nontaxable portion of all your distributions			13	439
14	Subtract line 13 from line 3. This is **your total basis in traditional IRAs for 2019 and earlier years**			14	5,561
15a	Subtract line 12 from line 7			15a	
b	Enter the amount on line 15a attributable to qualified disaster distributions from 2019 Forms 8915-C and 8915-D (see instructions). Also, enter this amount on 2019 Form 8915-C, line 22, **or** 2019 Form 8915-D, line 13, as applicable			15b	
c	**Taxable amount.** Subtract line 15b from line 15a. If more than zero, also include this amount on 2019 Form 1040 or 1040-SR, line 4b; or 2019 Form 1040-NR, line 16b			15c	
	Note: You may be subject to an additional 10% tax on the amount on line 15c if you were under age 59½ at the time of the distribution. See instructions.				

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 63966F Form **8606** (2019)

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For Example 31

Form 8606 (2019) Page 2

Part II **2019 Conversions From Traditional, SEP, or SIMPLE IRAs to Roth IRAs**
Complete this part if you converted part or all of your traditional, SEP, and SIMPLE IRAs to a Roth IRA in 2019.

16	If you completed Part I, enter the amount from line 8. Otherwise, enter the net amount you converted from traditional, SEP, and SIMPLE IRAs to Roth IRAs in 2019	16	6,000
17	If you completed Part I, enter the amount from line 11. Otherwise, enter your basis in the amount on line 16 (see instructions)	17	439
18	**Taxable amount.** Subtract line 17 from line 16. If more than zero, also include this amount on 2019 Form 1040 or 1040-SR, line 4b; or 2019 Form 1040-NR, line 16b	18	5,561

Part III **Distributions From Roth IRAs**

RECHARACTERIZATIONS OF ROTH CONVERSIONS

The Code allows taxpayers to reverse a conversion of a traditional IRA to a Roth IRA. This process is known as recharacterization. Recharacterizing conversions allows taxpayers a "do-over" if they determine that the timing of the conversion was not ideal or if the value of the IRA dropped significantly after the original conversion. Prior to December 31, 2017, after recharacterizing the conversions, the taxpayer could reconvert the balance after 30 days. The TCJA eliminated the reconversion option.[158]

ROLLOVERS OF MILITARY DEATH BENEFITS[159]

Special Code provisions allow taxpayers who receive certain military death benefits to contribute those benefits to a Roth IRA as if they were qualified rollovers. The two benefits that can be rolled over into Roth IRAs are the $100,000 death gratuity for servicemembers who die on active duty[160] and proceeds from Servicemembers Group Life Insurance (SGLI).[161] SGLI is available to servicemembers on active duty, providing up to $400,000 in benefits based on the level of coverage selected by the servicemember.[162]

These deemed rollovers are not considered contributions for purposes of annual contribution limits and are not subject to any limits based on MAGI. They do not count as a rollover for purposes of the one-rollover-per-year rule. The rollovers must be completed before the end of the 1-year period beginning on the date that the beneficiary receives the death benefit. Amounts rolled over are treated as part of the taxpayer's basis in the Roth IRA.

OTHER TOPICS

PLANS LEFT WITH PREVIOUS EMPLOYERS

Sometimes people leave companies and do not realize that they have balances remaining in qualified retirement accounts. This is particularly true if the company made mandatory contributions or matching contributions after the employee's separation date.

Practitioners may want to advise their clients on ways to keep track of their retirement benefits, such as keeping documentation, making sure their former employer has their new address, and rolling over retirement funds instead of leaving them with prior employers.

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158. IRC §408A(d)(6)(B)(iii). See also *IRA FAQS - Recharacterization of IRA Contributions.* Jan. 15, 2020. IRS. [irs.gov/retirement-plans/ira-faqs-recharacterization-of-ira-contributions] Accessed on Feb. 3, 2020.

159. IRC §408A(e)(2).

160. 10 USC §§1477 and 1478.

161. 38 USC §1967.

162. *Servicemembers Group Life Insurance (SGLI).* Aug. 5, 2019. U.S. Army. [myarmybenefits.us.army.mil/Benefit-Library/Federal-Benefits/Servicemembers-Group-Life-Insurance-(SGLI)?serv=122] Accessed on Jan. 1, 2020.

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If the employer's plan is a SEP IRA or a SIMPLE IRA, one method of discovering the existence of the plan is to request an IRS transcript showing any Forms 5498, *IRA Contribution Information*, on file for the taxpayer.[163] Because financial institutions are required to file an annual Form 5498 for each person for whom they maintain any IRA (or deemed IRA under IRC §408(q)) showing the yearend balance of the account,[164] any IRAs in a taxpayer's name will be discoverable using this method.

Discovering 401(k) accounts with former employers may be more difficult. Taxpayers who believe that there are funds in their names might want to use the following tools.

1. The Pension Benefit Guaranty Corporation has a search tool for unclaimed pensions. This tool can be found at **uofi.tax/20a2x1** [www.pbgc.gov/search-unclaimed-pensions].
2. The abandoned plan database is provided by the U.S. Department of Labor (DOL) to track plans that have been terminated. The database provides the contact information of the qualified termination administrator (QTA). The employee must know the plan name, employer name, or the QTA name to search this database, which is found at **uofi.tax/20a2x2** [www.askebsa.dol.gov/AbandonedPlanSearch].
3. The DOL provides free access to all Forms 5500 filed with the DOL since January 1, 2010.[165] Their website, **uofi.tax/20a2x3** [www.efast.dol.gov/portal/app/disseminate?execution=e1s1], allows people to search using various criteria, including plan name, sponsor name, and plan administrator.

According to a recent Government Accountability Office (GAO) study,[166] 17 states received $35 million in unclaimed retirement savings in 2016. Each state provides a method for people to search for unclaimed property remitted to the state in their name. Individuals should search the database in every state in which they have resided.

Note. The GAO made two recommendations to the IRS in its report.

1. The IRS should clarify if transfers of unclaimed savings from employer-based plans are distributions and which, if any, tax reporting and withholding requirements apply to such distributions.
2. The IRS should consider adding retirement savings transferred to the states as one of the exceptions allowing additional time to roll over retirement distributions.

Note. The unclaimed property database for the State of Illinois can be found at **uofi.tax/20a2x4** [icash.illinoistreasurer.gov].

163. See *Transcript Types and Ways to Order Them.* Dec. 21, 2019. IRS. [www.irs.gov/individuals/tax-return-transcript-types-and-ways-to-order-them] Accessed on Feb. 18, 2020.

164. Instructions for Forms 1099-R and 5498.

165. *Form 5500/5500-SF Filing Search**. U.S. Department of Labor. [efast.dol.gov/portal/app/disseminate?execution=e1s1] Accessed on Feb. 3, 2020.

166. *RETIREMENT ACCOUNTS Federal Action Needed to Clarify Tax Treatment of Unclaimed 401(k) Plan Savings Transferred to States.* U.S. Government Accountability Office. Jan. 2019. [www.gao.gov/assets/700/696525.pdf] Accessed on Jan. 3, 2020.

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PROHIBITED TRANSACTIONS

Employer-sponsored retirement accounts and IRAs must avoid certain types of transactions in order to maintain their tax-preferred status. Any person who participates in a **prohibited transaction** is subject to a tax of 15% of the amount involved in the transaction (15% excise tax).[167] In addition, if the transaction is not corrected in a timely manner, there is an additional tax equal to 100% of the amount involved.[168]

> **Caution.** The rules related to prohibited transactions are complex and there are many exceptions to the prohibitions. The following material is intended only as an introduction to the topic.[169]

Generally, the following transactions within a qualified retirement plan or IRA are prohibited. The prohibition applies to indirect as well as direct arrangements.[170]

1. Selling, exchanging, or leasing any property between a plan and a disqualified person
2. Lending money or extending credit between a plan and a disqualified person
3. Furnishing goods, services, or facilities between a plan and a disqualified person
4. A disqualified person's transfer of plan income or assets to, or use of them by or for their benefit
5. A fiduciary's act by which they deal with plan income or assets in their own interest
6. A fiduciary's receipt of consideration for their own account in a transaction that involves plan income or assets from any party dealing with the plan

> **Note.** A disqualified person may receive any benefit to which they are entitled as a plan participant or beneficiary (such as a participant loan), but the benefit must be on the same terms as for all other participants and beneficiaries.[171]

The term "disqualified person" means a person who is one of the following.[172]

- A fiduciary of the plan
- A person providing services to the plan
- An employer, any of whose employees are covered by the plan
- An employee organization, any of whose members are covered by the plan
- An owner, direct or indirect, of 50% or more of the employing entity that establishes the plan
- A **member of the family** of any individual disqualified under the above provisions (Family members of the disqualified person include their spouse, ancestor, lineal descendant, and any spouse of a lineal descendant.[173])

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167. IRC §4975(a).
168. IRC §4975(b). See also Treas. Reg. §54.4975-1.
169. *Retirement Topics - Prohibited Transactions.* Jan. 9, 2020. IRS. [www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-prohibited-transactions] Accessed on Jan. 14, 2020.
170. IRC §4975(c).
171. *Retirement Topics - Prohibited Transactions.* Oct. 17, 2019. IRS. [www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-prohibited-transactions] Accessed on Dec. 28, 2019.
172. IRC §4975(e).
173. IRC §4975(e)(6).

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- An entity that is at least 50% owned, directly or indirectly, by disqualified persons
- An officer, director, a 10% or more shareholder, or a highly compensated employee of an entity treated as a disqualified person
- A 10% or more (in capital or profits) partner of an entity treated as a disqualified person

Thiessen v. Comm'r[174]

The taxpayers transferred their tax-deferred retirement funds into newly formed IRAs. They used the IRA funds to acquire the initial stock of a newly formed C corporation. The IRAs were the only shareholders in the corporation.

The corporation purchased the assets of an existing business from another taxpayer. Under the terms of the purchase agreement, the corporation provided a promissory note to the seller for the remaining balance of the purchase price. The taxpayers guaranteed the promissory note.

The court agreed with the IRS that the guarantee constituted a prohibited transaction because guarantees are an indirect extension of credit to the IRA. As a result, the IRAs were deemed to have distributed all the assets to the taxpayers in a taxable transaction.

In addition, the court determined that the 6-year statute of limitations applied to the transactions because the unreported distribution was in excess of 25% of the gross income reported on the return and the taxpayers did not adequately disclose the prohibited transactions.

> **Note.** For more information on *Thiessen v. Comm'r,* see the 2016 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 6: Rulings and Cases. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Peek v. Comm'r[175]

This case involves two taxpayers, Mr. Peek and Mr. Fleck. Like *Thiessen*, the taxpayers used rollovers to IRAs to fund the purchase of stock in a newly established corporation that then used the funds to purchase the assets of an existing business from an unrelated party. The taxpayers also executed personal loan guarantees with respect to the purchase.

The original transactions occurred in 2001 when the taxpayers used the IRA funds to acquire the target company. They structured the transactions in accordance with a plan developed by a tax-plan promoter.

In 2003 and 2004, the taxpayers transferred their stock from their traditional IRAs to Roth IRAs and included the value of the stock transferred in income each year. In 2006, after the stock had significantly appreciated in value, the taxpayers directed their Roth IRAs to sell the stock.

The court ruled that the 2001 loan guarantees caused the accounts holding the stock to cease to be IRAs. The IRS did not attempt to assess taxes on the 2001 distributions. However, because the original accounts were not IRAs, the successor Roth IRAs were also not qualified IRAs. Accordingly, the gain from the sale of the stock was not sheltered and was taxable in the years the proceeds were received.

In addition to income taxes, the taxpayers were liable for the 20% accuracy-related penalty for negligence or disregard of rules or regulations. The taxpayers argued that they acted with reasonable cause and in good faith regarding the transactions because they relied on the advice of the CPA who promoted the plan they used to structure the arrangements. However, the court noted that by using a plan promoter, the taxpayers could not reasonably and in good faith rely on the promoter's advice. (The court quoted *106 Ltd v. Comm'r*[176] in saying "promoters take the good-faith out of good-faith reliance.")

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174. *James and Judith Thiessen v. Comm'r*, 146 TC No. 7 (2016).

175. *Lawrence F. Peek and Sara L. Peek, Darrell G. Fleck and Kimberly J. Fleck v. Comm'r*, 140 TC 216 (May 9, 2013).

176. *106 Ltd v. Comm'r,* 684 F.3d 84 (Jun. 22, 2012).

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Rutland v. Comm'r[177]

The taxpayers involved in this case were five individuals and the corporation sponsoring the employer retirement plan under issue. The individuals, who were all owner-employees of the corporation, sold property to the plan. In addition to being relieved of an existing mortgage on the property, the individuals received a promissory note for the remaining value of the property sold to the plan. The corporation then leased the property from the plan. The prohibited transactions were corrected five years after the initial transactions.

The IRS determined that each of the individuals was liable for the excise tax on three prohibited transactions. (The IRS later conceded to the court that the outstanding mortgage on the property did not cause the transaction to be a prohibited one.)

1. The sale of the property to the plan
2. The transaction involving the outstanding mortgage
3. The issuance of a promissory note to the sellers

In addition, the IRS assessed the excise tax on the corporation for leasing the property from the related plan.

Of the five individuals, one individual was ruled not to be a disqualified person because at no time did he own 10% or more of the corporation's stock. That individual was released from imposition of the excise tax.

Two of the remaining individuals argued that although they were disqualified persons at the time of the transaction, severing their ties to the company should have relieved them of the burden of the excise tax. The court ruled that a disqualified person cannot avoid liability merely by changing their legal status after engaging in the prohibited transaction. To avoid the liability, they must correct the transaction.

Despite the fact that the sale of the property and the issuance of a promissory note were part of the same transaction, the court ruled that the excise tax could be applied to each. Thus, the four individuals were liable for the excise tax on the full sales price and the amount of the promissory note. In addition, the excise tax was calculated for **each tax year** that the promissory note and the lease agreement were active. The court agreed with the IRS method of calculating the tax.

The lease arrangement might have been exempted from being categorized as a prohibited transaction if it had met the definition of "qualifying employer real property" under the Code. However, upon examining the facts, the court ruled that the property did **not** meet the requirements to qualify as an exception to the rules.

The taxpayers also argued that they acted in good faith and therefore should be exempt from the excise tax. The court acknowledged their good faith but responded that the law did not recognize that as a defense to the imposition of the excise tax.

The final arguments of the petitioners were likewise unconvincing to the court. They argued that the statute of limitations had expired, but the court noted that the prohibited transactions were not adequately disclosed and, accordingly, the 6-year statute of limitation applied. The court noted that on the Form 5500, *Annual Return/Report of Employee Benefit Plan,* filed by the plan for the year of the transaction, the question, "Did any transaction, involving plan assets, involve a person known to be a party-in-interest?" was answered "No."

Each of the individuals in this case paid over $140,000 in excise taxes on transactions involving property initially worth only $430,000. In addition, the corporation paid over $19,000 in excise taxes on the lease arrangement. This case highlights how quickly prohibited transactions can become very expensive.

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177. *Hulan E Rutland, et al. v. Comm'r*, 89 TC 1137 (1987).

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