

Retirement Distributions to the Terminally Ill

March 11, 2024

Take-Away: The SECURE Act 2.0 provides yet another exception to the early distribution excise tax, the *Terminally Ill Distribution*. The big question is how many qualified plan sponsors will be willing to amend their plans to include this newest exception to the early distribution penalty.

Background: One of the important changes from the SECURE Act 2.0 was the exemption from the 10% early distribution excise tax (i.e., prior to age 59 ½) when a plan participant is certified as being terminally ill, aka a *Terminally Ill Distribution*. In its Notice 2024-02 the IRS provides guidance on how this exception is determined and implemented. While the distribution is exempt from the 10% penalty, the distribution from the retirement account itself is still taxed. What is important to remember is that this is an *optional* provision that the plan sponsor (i.e., the employer) does not have to add to its qualified retirement plan. Some of the basic provisions of this exception to the early distribution penalty follow.

Retirement Plans: The Notice clarifies that the types of plans that can provide for the *Terminally Ill Distribution* are both defined contribution and defined benefit qualified plans under IRC 401(a), and annuity plans under both IRC 403(a) and IRC 403(b), and IRAs. However, a deferred compensation plan under IRC 457(b) sponsored by a state or local government is not eligible to provide for a *Terminally Ill Distribution* (primarily because it is not considered a qualified retirement plan, nor is a 457(b) plan that is sponsored by a tax-exempt organization.)

Physician Certification: To be eligible for a *Terminally Ill Distribution*, the plan participant must be certified by a physician as having an illness or physical condition that can reasonably be expected to result in death in 84 months or less after the date of the certification. The physician must be a Doctor of Medicine or osteopathy legally authorized to practice medicine and surgery by the State in

which the doctor performs those functions. The Certification must contain the following information:

- A statement that the illness or condition can reasonably be expected to result in death in 84 months or less;
- A narrative description of the evidence used to support that statement;
- The name and contact information of the certifying physician;
- The date the physician examined the participant or reviewed the evidence provided by the participant; and
- A signed and dated attestation from the physician that by signing the statement the physician confirms that the physician composed the narrative description based on an examination of the participant or review of the evidence provided by the participant.

Certificate Delivery: The participant must provide the Certification to the Plan Administrator before he/she receives the *Terminally Ill Distribution*, but he/she does not have to provide to the Administrator the underlying documentation on which the Certification is based. The Plan Administrator may not rely on a self-certification filed by a physician-participant.

Plan Amendments: As noted earlier, the Notice expressly states that the decision to authorize a *Terminally Ill Distribution* is voluntary for the plan sponsor, as an exception to the 10% excise tax for early distributions. However, it is not an exception to other restrictions that apply to 401(k) and 403(b) plans, and thus the plan must first permit in-service distributions or hardship distributions.

Hardship Distributions: If a qualified plan does not permit a *Terminally Ill Distribution*, but the plan does authorize permissible in-service distributions, the plan participant may treat the distribution as a *Terminally Ill Distribution* on his/her federal income tax return, reporting it on Form 5329. Yet in this situation the plan participant must still obtain the physician's certification prior to the distribution and retain a copy with their files in the event the IRS later requests a copy. The IRS Notice provides an example of a hardship distribution after obtaining a physician's certificate.

Definition of Terminally Ill: The definition of terminally ill corresponds to the definition that is used under the Social Security Act.

Paybacks: Like many of the more recent CARES Act and SECURE Act exceptions to early distributions for specific reasons, e.g., birth, adoption distributions, the *Terminally Ill Distribution* exception contemplates the participant re-contributing the distribution. The re-contribution can be to the same plan or to another qualified retirement plan in which the individual is a participant and to which rollovers may be made, including an IRA. If the distributing plan did not permit a *Terminally Ill Distribution*, but the participant treated it as an allowed distribution, the participant can re-contribute the amount to an IRA. The limitation is that the re-contribution of a *Terminally Ill Distribution* may be re-contributed at any time during the 3-year period that begins on the date of the distribution (the same as for the birth or adoption distribution re-contribution rules.)

Conclusion: Many 401(k) plans already authorize in-service or financial hardship distributions to plan participants. If that is the case, the participant can report such a distribution as a *Terminally Ill Distribution* on their personal income tax return. Therefore, plan sponsors with these 'other' in-service distribution options may not want to amend their qualified plans which would increase their burden of administering requests for *Terminally Ill Distributions*.