**Take-Away:** We all know about the 10% excise tax, aka *penalty,* for taking a distribution from an IRA prior to age 59 ½. We are also aware of the several statutory *exceptions* to this excise tax, although keeping these *exceptions,* or safe harbors, straight in our minds can be more of a challenge. Often the technical rules of these statutory *exceptions* cause considerable confusion.

**Background:** The excise tax for early distributions is located at IRC 72(t). The general rule is that the account owner must pay a 10% penalty on any distribution from a qualified retirement plan [defined in IRC 4974(c).] The IRC 4974(c) definition includes all types of retirement plans, including 401(k) plans and IRAs [IRC 408.] The penalty is an amount equal to 10% of the portion of such amount which is includible in gross income. [IRC 72(t)(1).] Then, IRC 72(t)(2) provides several statutory *exceptions*. Some of these *exceptions* are for all types of qualified retirement plans, others are only for certain plans. These statutory *exceptions* are listed on the IRS webpage.

> **Example:** There is an *exception* to the early distribution penalty for distributions that are used for qualified education expenses. However, those distributions may come only from an individual retirement plan, i.e., an IRA.

> **Example:** The IRC 72(t)(2)(c) *exception* seems to apply to any distribution to an alternate payee pursuant to a qualified domestic relations order, or QDRO. So, it reads like a QDRO would apply to any type or retirement plan, right? But then in IRC 72(t)(3)(A) Congress then says that this *exception* only works for a distribution from a 401(k) or 403(b) employer sponsored plan, not IRAs.

**Technical Eligibility Rules:** Some of the statutory *exceptions* are limited

both in time and to specific retirement accounts, which makes qualifying for an *exception* even more challenging.

> **Example:** The recent Consolidated Appropriations Act creates a new IRC 72(f)(2)(1) which permits an early distribution, penalty-free, of no more than $1,000 for emergency personal expenses, but only if the distributions is from '*an applicable eligible retirement plan, as defined in subparagraph (H)(vi)(1).*" But then, when you go to (H)(vi)(1) you read that it does not do anything other than cross-reference to IRC 402(c)(8)(B), which in turn refers to six different types of retirement plans: *(i)an individual retirement account described in section 408(a); (ii)an individual retirement annuity described in section 408(b); a qualified trust; (iv) an annuity plan described in section 403(a); an eligible deferred compensation plan described in section 457(b) which is maintained by an eligible employer described in section 457(e)(1)(A); and (vi) an annuity contract described in section 403(b).*" **Note, however, that there is no reference to a 401(k) plan.** Thus, this new emergency personal expense statutory *exception,* like the home-buyer exception, does not apply to 401(k) accounts. Moreover, this new exception only applies to distributions made **after December 31, 2023.**

The U.S. Tax Court has recently issued a couple of decisions that deal with the statutory *exceptions* to the 10% penalty, which reflect the confusion of account owners when the owner took an early distribution from his or her retirement account.

***Edward George Shlikas v Commissioner, Tax Court Summary Opinion 2024-10 (June 20, 2024)***

> **Facts:** Mr. Shlikas and his brother jointly owned a home that they inherited from their mother. In 2019, when he was 50 years old, Mr. Shlikas took two distributions from his TIAA-CREF retirement accounts, and with these proceeds he bought-out his brother's interest in the home: the distributions from a 403(b) account and an IRA totaled $137,000. This $137,000 amount was reported on Mr. Shlikas' 2019 Form 1040, based

on a Form 1099-R issued by TIAA-CREF. The IRS assessed a 10% penalty because Mr. Shlikas was not then 59 ½ years old.

**Argument:** Mr. Shlikas argued that the qualified home-buyer *exception* of IRC 72(t)(2)(F) applied to the distributions that he received in 2019.

**Tax Court:** The Tax Court disagreed with Mr. Shlikas's claims because he did not show what type of retirement accounts the distributions came from. Specifically, he could not identify what type of retirement accounts that he had owned. Mr. Shlikas even argued that part of the distribution was from a Roth IRA, but the Form 1099-R that he received reported the entire $137,000 distribution as a taxable distribution. It was Mr. Shlikias's burden to show that the Notice of Deficiency was incorrect; consequently, it was his burden to show that his early distribution was sheltered from penalty by the qualified home-buyer safe harbor, which he failed to do. [Aside: The Tax Court did not investigate another question, which was whether the purchase of the brother's interest in the inherited home was within the qualified home-buyer distribution *exception*.]

***Caren Kohl v Commissioner, Tax Court Summary Opinion 2024-4 (April 25, 2024)***

**Facts:** Ms. Kohl struggled to pay her rent. To avoid her eviction, she withdrew $10,000 from her retirement account, unclear from the court's summary, but it appears to have been an IRA. She did not report this amount in her 2018 income, nor did report or pay the 10% penalty. The IRS sent her a Notice of Deficiency.

**Argument:** Ms. Kohl conceded that she needed to include the distribution in her gross income for 2018. However, she claimed that she should not have to pay the penalty as well, pointing to the 2022 legislation that created the new IRC 72(t)(2)(l) exception to the 10% penalty for distributions made to address a taxpayer's economic hardship. The IRS countered that retirement accounts are not supposed to be emergency funds.

**Tax Court:** The Court agreed with the IRS's position. The tax-favored treatment afforded retirement accounts is so that an individual can save for when she leaves the workforce, not to deal with emergencies that arise in life. Even though Congress created this new safe harbor for certain personal expenses, that safe harbor is only for $1,000 if it had applied but it did not since be became only starting in 2023. At best, had Ms. Kohl been successful in her argument, she would only have reduced the amount subject to the penalty to $9,000, thus in a best-case scenario she would have saved herself $100 in penalties.

**Conclusion:** The Judge in the *Shlikas* case summed up pretty much the whole issue of the early distribution penalty and the relatively narrow statutory *exceptions* to the penalty:

> *"The Court …lacks general equitable powers. There is no authority in the Code or caselaw for an equitable or hardship exception to the imposition of additional tax under section 72(t) on early distributions from a retirement account."*

A constant refrain in my missives that you are no doubt tired of reading is that its well beyond time for Congress to simplify the 'crazy-quilt' rules that applies to multiple types of retirement plans, bringing a single set of contribution and distribution rules to all types of retirement accounts.