DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

CC:NTA
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MAY 24, 1999

MEMORANDUM FOR W. VAL OVESON
NATIONAL TAXPAYER ADVOCATE
Attn: Letitia Thomas

FROM: Kirsten B. Wielobob KW
Acting Counsel to the National Taxpayer Advocate

SUBJECT: Taxpayer [redacted]

This memorandum responds to your April 19, 1999 request for legal assistance concerning [redacted] claim that he is not liable for a 10 percent tax on a premature distribution from his IRA.

ISSUES

1. Whether the disability exception in IRC § 72(t) applies to the disability of an IRA participant's spouse, thereby relieving him of liability for the 10% tax on premature distributions for the IRA.

2. Whether the taxpayer can be excepted from the 10% tax on premature IRA distributions under any other provision.

CONCLUSIONS

1. The exception to the 10% tax applies only to the established disability of the owner of the IRA.

2. There is no other provision that would allow [redacted] to avoid taxation on the premature distribution of his IRA.

FACTS

In [redacted], [redacted] withdrew funds from his individual retirement account ("IRA") and divided them with his wife while they were separating. [redacted] was the sole contributor and the sole owner of the IRA. At the time of the distribution, [redacted] was less than 59½ years old, gainfully employed, and did not otherwise qualify to make an early withdrawal from the IRA without incurring the 10% tax under I.R.C. § 72(t). He did not roll over any part of the IRA into another IRA. The taxpayer agrees that he is liable for income tax on the withdrawn amounts, but asserts that he is exempt from the 10% early withdrawal tax because his ex-wife was "hearing-impaired and mentally unstable" when the funds were withdrawn. The [redacted] divorce was finalized in [redacted].

DISCUSSION

Employees and self-employed individuals may contribute up to $2000 per year of their earned income to an IRA. An additional amount may be contributed to a separate account owned by a non-working spouse. In addition, individuals may roll over certain early distributions from other retirement accounts into IRAs. If a taxpayer is below a certain income threshold, the taxpayer may exclude from income qualifying contributions to such accounts in the year of contribution. Whether or not the contribution is excludible from tax, any income earned on these accounts accrues tax-free until such income is distributed. As funds are withdrawn from the IRA, any previously untaxed contributions and any income that accrued tax-free are subject to tax. Thus, IRAs provide a tax benefit by allowing a deferral of tax liability.

1. **Disability Exception to Ten Percent Tax.**

Congress's main reason for extending favorable tax treatment through IRAs is to encourage retirement savings. To discourage taxpayers from using these accounts as tax-free savings accounts for purposes other than retirement, however, I.R.C. § 72(t)(1) imposes a special 10% tax on early distributions from IRAs and other tax-favored retirement plans:

> If any taxpayer receives any amount from a qualified retirement plan [defined in I.R.C. 4974(c) to include individual retirement accounts and individual retirement annuities], the taxpayer's tax under this chapter for the taxable year in which such amount is received shall be increased by an amount equal to 10 percent of the portion of such amount which is includible in gross income.

Section 72(t)(2) excepts from the 10% tax distributions made on or after the participant reaches age 59½, dies, or becomes disabled.

[redacted] argues that he is entitled to the disability exception because his wife was "hearing impaired and mentally unstable." The "disability exception" in section 72(t)(2)(A)(iii), however, applies only to distributions that are "attributable to the employee's being disabled within the meaning of subsection (m)(7)." This means that the "employee" covered by the retirement plan (in other words, [redacted] must be disabled. [redacted] does not contend that he was disabled. Second, the disability must be one within the meaning of subsection (m)(7); that is:

> An individual shall be considered to be disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of a long-conditioned and indefinite duration. An individual shall not be considered disabled unless he furnishes proof of the existence thereof in such form and manner as the Secretary may require.

The disability must preclude the owner of the IRA account or beneficiary of a pension plan from earning income. [redacted] does not claim such a disability for himself. Further, even if the disability could be applied to his exwife, [redacted] has not claimed or furnished proof that her alleged physical and mental impairments kept her from engaging in substantial gainful activity. [redacted] withdrew his IRA assets in order to separate marital assets in a separation and divorce from his wife. Based on the facts presented, the disability exception to the 10% tax on premature IRA distributions does not apply to the [redacted] case.

2. Other Possible Exceptions to Ten Percent Tax.

When taxpayers divorce, Code section 408(d)(6) allows one spouse to transfer all or part of an IRA to the other spouse ("transferee spouse") under a divorce or separation agreement without a tax effect on the transfer. Such a transfer is not a distribution by the owner of the IRA and, thereafter, the transferee spouse is treated as the owner of the IRA. The basis in the IRA (for any previously taxed contributions) passes to the transferee. Treas. Reg. § 1.408-4(g)(1). When the transferred IRA is later distributed, the transferee spouse will be liable for any tax, including the 10% tax under section 72(t) on a premature distribution, that results from the distribution. Publication 590, "Individual Retirement Arrangements" explains how divorcing spouses can transfer IRAs by changing the name on the IRA, by having the IRA trustee transfer the assets to a new IRA, or by withdrawing assets and rolling them over into a new IRA for the spouse.

[redacted] withdrawal of assets would not qualify as an authorized division of the IRA in that [redacted] did not roll the funds into a new IRA for [redacted] within the prescribed time period. Instead, [redacted] caused the IRA to be distributed and then divided the IRA assets with [redacted] for immediate use.

We also considered whether [redacted] could have avoided the 10% tax on the premature distribution by requesting a "qualified domestic relations order"

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("QDRO"), in the divorce action. Generally, if a QDRO compels a distribution of funds from a qualified retirement plan to a spouse or a payee other than the covered employee, I.R.C. § 72(t)(2)(C) excepts the distribution from the 10% premature distribution tax. Section 72(t)(3)(A), however, precludes the QDRO exception in section 72(t)(2)(C) from applying to IRAs. Therefore, a QDRO would not benefit [redacted] with respect to the [redacted] distribution from his IRA.

RECOMMENDATIONS

It appears, on the facts you have presented, that [redacted] is not excepted from the 10% tax on the premature distribution of funds from his IRA in [redacted] You might further explore the facts concerning the division of the IRA assets during the separation and divorce to determine if the IRA, or any part of it, was transferred to [redacted] *before* the distribution was made. If so, [redacted], rather than [redacted], would be liable for the income tax on the distribution of assets from *her* IRA. Her health and employment status could then be measured against the criteria for the disability exception to determine whether the distribution to her was excepted from the 10% tax. Any amounts distributed to [redacted], however, are both taxable income and subject to the 10% tax.

If you have further questions, call Arlene Blume at 202-622-3166.