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When are early 401(k) withdrawals subject to income tax and the additional 10 percent tax? Let's take a look at *Soltani-Amadi v. Commissioner,*[1] a case from the Tax Court.

This is an interesting and important case that explains the tax law on early distributions from a 401(k) retirement plan and how at least one exception to the early withdrawal additional tax (Section 72(t) additional tax) applies.

In 2015 Lily Hilda Soltani-Amadi and Bahman Justin Amadi were residents of the State of New York and under 55 years of age. When they decided to buy their first home, they came up short on the money needed for a down payment. Ms. Soltani-Amadi worked for the State of New York and participated in the 401(k) retirement plan established by the State. This plan was considered both a qualified plan under Section 401(a) and exempt from income tax under Section 501(a). She asked for and received $6,686 from the plan, which went toward purchasing the house.

When the couple filed their joint tax return, they did not report the 401(k) distribution as a part of their taxable income. The IRS issued a notice of deficiency based on including the distribution from Ms. Soltani-Amadi's 401(k) plan in income and assessing the 10 percent tax (penalty) on the early withdrawal from this plan. The Amadis responded by filing a petition with the Tax Court. Ms. Soltani-Amadi stated that a representative told her that she would not be subject to the penalty because the distribution was for the purchase of first home.

Whether the distribution is includable in taxpayer's gross income

Gross income means all income from whatever source derived, including compensation, annuities, income from life insurance and endowment contracts, and pensions.[2]

Section 402(a) provides that "any amount actually distributed to any distributee by any employees' trust described in Section 401(a) which is exempt from tax under Section 501(a) shall be taxable to the distributee, in the taxable year of the distributee in which distributed, under Section 72 (relating to annuities)."[3] As mentioned previously, Ms. Soltani-Amadi participated in a 401(k) retirement plan that was both a qualified plan within the meaning of Section 401(a) and was exempt from income tax under Section 501(a). That is why the distribution of $6,686 was included in their taxable income. Also, the court explained that according to Section 402 only trust (i.e., the entity) is exempt from income tax under Section 501(a), not the beneficiaries of the employees' trust (i.e., the participating employees).

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[1] *Soltani-Amadi, et vir. v. Commissioner*, TC Summary Opinion 2019-19 (08/08/2019).
[2] Section 61(a).
[3] Section 402(a).

Citing *Weaver-Adams v. Commissioner,*[4] the Tax Court referred to the general rule which explains that distributions are taxable in the year received because contributions were made with “pre-tax dollars”. In that case, Ms. Weaver-Adams was an alternate payee of the 401(k) plan from her ex-husband’s employer under a Qualified Domestic Relations Order (QDRO) as part of their divorce decree. She received a distribution from this plan, and she reported this as nontaxable pension and annuity income. This led to a deficiency in her gross income and, consequently, an income tax assessment. The court held that “a distribution from a qualified retirement plan was taxable to the distributee as ordinary income if it was not rolled over into an eligible retirement”[5] plan based on the fact that distributions are paid from pre-tax dollars under Section 402(a) and Reg. 1.402(a)-(1)(a)(1) and (2).

Therefore, the Tax Court in the Amadi’s case held that the distribution from Ms. Soltani-Amadi’s 401(k) retirement plan was taxable and must be included in taxable income despite the fact that the advice from the plan representative was wrong.

Whether the 10 percent additional tax should apply

According to Section 72(t)(1), in a case of early distribution from a qualified retirement plan under Section 4974(c), an additional tax that equals 10 percent of the total distribution(s) shall be applied. Section 4974(c) provides a definition of “qualified retirement plan” which includes a plan described in Section 401(a) which is also exempt from tax under Section 501(a).[6] Thus, Lily Hilda Soltani-Amadi participated in the 401(k) retirement plan which was a qualified retirement plan under Section 4974(c) and was potentially subject to 10 percent additional tax under Section 72(t).

However, Section 72(t)(2) provides certain exceptions to the general rule under Section 72(t)(1). Distributions from an individual retirement plan, which are qualified first-time homebuyer distributions, are a part of the exception list. As mentioned above, Amadis decided to make a distribution from the 401(k) retirement plan to purchase their first home, and they considered this as the exception under Section 72(t)(2)(F).

The court indicated the main purpose of enacting Section 72(t) in 1974 by Congress was to prevent early distributions by individual taxpayers from qualified retirement plans. The court referred to the holding in *Dwyer v. Commissioner* [7] in which it held that Mr. Dwyer was liable for the 10 percent additional tax on a premature distribution from the qualified plan in 1989, pursuant to Section 72(t). In 1997 two exceptions were added by Congress by Public Law 105-34: distributions for higher education expenses and distributions for first home purchases. Section 72(t)(2)(F) provides that the 10 percent additional tax shall not apply to distributions from certain individual retirement plans which are qualified first-time homebuyer

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[4] *Gina B. Weaver-Adams v. Commissioner*, TC Memo 2014-73 (04/28/2014).

[5] *Gina B. Weaver-Adams v. Commissioner*, TC Memo 2014-73 (04/28/2014).

[6] Section 4974(c).

[7] *Robert J. Dwyer, et ux. v. Commissioner,* 106 T.C. 337, 340 (1996).

distributions.[8] However this Code Section does not provide any information about which plan is considered an "individual retirement plan." This definition can be found in Section 7701(a)(37) that involves only an individual retirement account (IRA) and annuity described in Section 408(a) and 408(b)respectively. According to these definitions, the term "individual retirement plan" can be applied only to individual retirement accounts and individual retirement annuities, such as IRAs and not to other types of retirement plans, such as 401(k) retirement plans. The distribution in this case was from the 401(k) retirement plan, which does not fall within the IRA category. Thus, a 401(k) retirement plan is not considered an "individual retirement plan," and the exception from Section 72(t)(2) for first-time homebuyers cannot be applied. So, the legislative history and analysis support the idea that the exception of 10 percent additional tax for first-time home purchase applies only for an IRA distribution. This is why Amadis were liable for 10 percent additional tax imposed by Section 72(t)(1).

Conclusion

This is an interesting case for taxpayers and tax professionals as it covers situations that deal with receiving an early distribution from a 401(k) retirement plan. It helps to provide solutions to such situations as whether these distributions are part of the taxable income and whether these distributions are subject to additional tax in the case of early distribution. Also, this case is a good example of the importance of tax advisers checking the text of the law in order to be sure whether special rules and exceptions can be applied for every particular client or situation.

[8] Section 72(t)(2)(F).