

## Neither hardship nor disability shielded taxpayer from early distribution penalty

The Tax Court has concluded that an individual who received a hardship distribution from his retirement plan because he claimed he was disabled couldn't escape the Code Sec. 72(t) early distribution penalty. Neither the taxpayer's hardship nor disability due to post-traumatic stress and depression proved to be sufficient grounds to avoid the additional 10% tax.

**Background.** In general, a retirement plan can make a hardship distribution only: if the plan permits such distributions; because of an immediate and heavy financial need of the employee; and in an amount necessary to meet the financial need. (Reg. § 1.401(k)-1(d)(3)) Hardship distributions are generally subject to income tax in the year of distribution and, if the employee is under the age of 59 1/2, to the 10% early distribution tax unless some exception to this early distribution tax applies. However, hardship distributions aren't subject to mandatory 20% income tax withholding.

Under Code Sec. 72(t)(1), a 10% penalty is imposed on early distributions (i.e., distributions before age 59 1/2) from a qualified retirement plan, unless one of the exceptions enumerated in Code Sec. 72(t)(2) applies. One of those exceptions, as described under Code Sec. 72(t)(2)(A)(iii), applies to a distribution that's attributable to an individual's being "disabled." Disability is defined under Code Sec. 72(m)(7) as unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death, or to be of long-continued and indefinite duration. Reg. § 1.72-17A(f)(2)(vi) provides that the standard for a mental illness impairment to qualify as disability is that the illness require continued institutionalization or the constant supervision of the individual.

**Facts.** Eugene Dollander, who worked as a nurse for the Department of Veterans Affairs (VA), received an in-service financial hardship distribution from his qualified retirement plan in 2005, before he had reached age 59 1/2. He claimed that he was eligible for the disability exception to the 10% early distribution tax because he suffered mental health difficulties, including post-traumatic stress disorder and depression, following the death of a patient in his care.

He contended that he shouldn't be subject to the 10% additional tax under Code Sec. 72(t) because the distribution from his plan was approved as a "financial hardship in-service withdrawal" arising from his negative monthly cashflow. Further, he claimed that he received the distribution because he was disabled.

**Court's findings.** The Tax Court rejected Dollander's attempt to avoid the 10% additional tax based on a hardship argument. Code Sec. 72(t) is explicit: if any taxpayer receives any amount from a qualified retirement plan, his tax is increased by an amount equal to 10% of the portion of that amount which is includable in gross income—unless one of the enumerated exceptions apply. Financial hardship is not one of the exceptions in Code Sec. 72(t)(2).

In addition, while acknowledging Dollander's illnesses, the Court found that he wasn't disabled for purposes of Code Sec. 72(t)(2)(A)(iii) and Code Sec. 72(m)(7). A taxpayer is considered

disabled for this purpose only if he is unable to engage in any substantial gainful activity by reason of a medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued or indefinite duration. The regs contemplate that only medical conditions of a nature so severe as to prevent substantial gainful activity result in a taxpayer's being considered disabled. (Reg. § 1.72-17A(f)(2))

The Court reasoned that not only did Dollander's doctor say he was expected to fully recover from his mental illness, but the treatment he received didn't require institutionalization or constant supervision. What's more, in 2005 he continued working at the VA at the same pay grade and earning the same salary as before his impairment was diagnosed. He also engaged in a business activity throughout the year that required him to travel a significant distance numerous times. Further, after retiring from the VA in 2006, he got a full-time job with another employer.