Article from:

Taxing Times

May 2011 – Volume 7 Issue 2

THE IRS CONSIDERS MODIFICATIONS TO SEPPs

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Section 72(t)(2)(A)(iv)[1] sets forth an exception to the 10 percent penalty tax on premature distributions from qualified retirement plans for certain distributions which are part of a series of substantially equal periodic payments ("SEPPs"). However, the penalty tax that is avoided under this "SEPP Exception" generally is recaptured under section 72(t)(4) if the series of SEPPs is modified within five years or before the taxpayer attains age 59½ (the "Recapture Rule"). Similar rules apply to premature distributions from non-qualified annuity contracts under section 72(q).

Rev. Rul. 2002-62[2] provides guidance on what constitutes a series of SEPPs within the meaning of section 72(t)(2)(A)(iv). This revenue ruling also briefly addresses certain circumstances in which the series of payments will and will not be treated as modified for purposes of the Recapture Rule. Aside from these circumstances, there is little guidance in the Code or the legislative history of the SEPP Exception on the extent to which a distribution that differs from others in a stream of SEPPs nevertheless will be treated as covered by the SEPP Exception, and thus will not be viewed as a modification to the stream that triggers the Recapture Rule.

In addition, the Service concluded that the failure to make a distribution as scheduled, and the subsequent make-up payment, would not constitute a modification to the series of SEPPs.

Recently, the Internal Revenue Service (the "Service") in PLR 201051025 (Sept. 30, 2010) concluded that, under the facts of the case, an initial lump sum payment from an IRA which differed in amount from subsequent distributions in a series of SEPPs was covered under the SEPP Exception and did not result in a modification to the series.[3] In addition, the Service concluded that the failure to make a distribution as scheduled, and the subsequent make-up payment, would not constitute a modification to the series of SEPPs. This private letter ruling reflects the Service's willingness to look beyond a strict reading of the Code, legislative history and Rev. Rul. 2002-62 in applying the SEPP Exception and the Recapture Rule. This article discusses the SEPP Exception, looks at whether certain deviations in a stream of SEPPs constitute modifications of the stream for purposes of the Recapture Rule, and considers the Service's conclusions in PLR 201051025.

THE 10 PERCENT PENALTY TAX, THE SEPP EXCEPTION AND THE RECAPTURE RULE

Section 72(t) provides generally that if an employee receives any amount from a "qualified retirement plan"[4] prior to the date on which the employee attains age 59½, the taxpayer's income tax is increased by an amount equal to 10 percent of the portion of such amount which is includible in gross income, subject to certain exceptions. The SEPP Exception in section 72(t)(2)(A)(iv) provides that this 10 percent penalty tax does not apply to distributions which are part of a series of SEPPs (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of such employee and his designated beneficiary. Rev. Rul. 2002-62 provides that distributions will be treated as covered by the SEPP Exception if they are made in accordance with one of the three calculation methods described therein, namely (1) the "required minimum distribution method," (2) the "fixed amortization method," or (3) the "fixed annuitization method." As mentioned earlier, however, the section 72(t)(4) Recapture Rule provides that if a series of payments that is covered by the SEPP Exception is modified (other than by reason of death or disability) within five years or before the employee attains age 59½, the previously avoided 10 percent penalty tax is recaptured in the year of the modification, and the employee's tax for the year is increased by an amount equal to the tax which (absent the SEPP Exception) would have been imposed, plus interest for the deferral period.

The counterparts of these rules for non-qualified annuity contracts are set forth in section 72(q). Specifically, the 10 percent penalty tax on premature distributions from a non-qualified annuity contract is imposed under section 72(q)

(1), the SEPP Exception to this penalty tax is set forth in section 72(q)(2)(D), and the Recapture Rule for a modification to a series of SEPPs under a non-qualified annuity contract is provided in section 72(q)(3). The Service in Notice 2004-15 noted generally that the penalty tax provisions in section 72(q) were enacted by Congress for the same purpose as the penalty tax provisions in section 72(t). Hence, it seems appropriate to apply the SEPP Exception and the Recapture Rule under section 72(q) to non-qualified annuity contracts in the same manner that they are applied under section 72(t) to qualified retirement plans.[5]

WHAT CONSTITUTES A MODIFICATION OF SEPPS FOR PURPOSES OF THE RECAPTURE RULE?

The SEPP Exceptions under section 72(t)(2)(A)(iv) and (q)(2)(D) do not contain waiver provisions under which the Service can forgive a modification to a series of SEPPs that otherwise would trigger the application of the Recapture Rule. Rather, the SEPP Exceptions are drafted such that the Recapture Rules must apply if the series of SEPPs is modified within five years or prior to the date that the taxpayer attains age 59½. The only exception to the Recapture Rule, as articulated in sections 72(t)(4) and (q)(3), is that a modification by reason of death or disability will not trigger the Recapture Rules under those sections.

Aside from these references to modifications by reason of death or disability, neither the Code nor the regulations under section 72 define or discuss what constitutes a modification for purposes of the Recapture Rules. The legislative history of the SEPP Exception under section 72(t)(2)(A)(iv) indicates that payments will not fail to be SEPPs, and thus will not be viewed as resulting in a modification to the series of payments, solely because the payments vary on account of (1) certain cost of living adjustments, (2) cash refunds of employee contributions upon an employee's death, (3) a benefit increase provided to retired employees, (4) an adjustment due to the death of the employee's beneficiary, or (5) the cessation of a social security supplement.[6] Regarding the SEPP Exception under section 72(q)(2)(D), the Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982 prepared by the staff of the Joint Committee on Taxation (the "TEFRA Blue Book") states that the requirement that an amount be paid out as one of a series of "substantially equal" periodic payments is met whether it is paid as part of a fixed annuity, or as part of a variable annuity under which the number of units withdrawn to make each distribution is substantially the same.[7] Beyond this limited guidance, it has been up to the Service and the courts to interpret what constitutes a modification to a series of SEPPs.

The Service and the courts have demonstrated a willingness in some cases to overlook deviations in a stream of SEPPs for purposes of applying the Recapture Rule. For instance, the Service in Rev. Rul. 2002-62 expressed the following views about whether certain changes in a stream of SEPPs will be treated as modifications for purposes of the Recapture Rule under section 72(t)(4):

1. *Complete depletion of assets*. If, as a result of following an acceptable method of determining SEPPs, an individual's assets in an individual account plan or an IRA are exhausted, the resulting cessation of payments will not be treated as a modification of the series of payments.

2. *One-time change to required minimum distribution method.* An individual who begins distributions in a year using either the fixed amortization method or the fixed annuitization method may in any subsequent year switch to the required minimum distribution method to determine the payment for the year of the switch and all subsequent years, and the change in method will not be treated as a modification within the meaning of section 72(t)(4).

   Observation. The Service's position in Rev. Rul. 2002-62 that a change of method will not be viewed as a modification only if the change is to the required minimum distribution method, and only if the change is made once, appears to be much narrower than the position expressed in the legislative history of the SEPP Exception. The legislative history of section 72(q)(2)(D) indicates that a change of method to any method which satisfies the SEPP Exception should not be treated as a modification, and does not limit the number of times that such a change may occur. Specifically, the Conference Report to the Tax Reform Act of 1986 explains:

   > ... if distributions to an individual are not subject to the [ten percent penalty] tax because of application of the substantially equal payment exception, the tax will nevertheless be imposed *if the individual changes the distribution method prior to age 59½ to a method which does not qualify for the exception*.

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> ... Thus, for example, if an individual begins receiving payments in substantially equal installments at age 56, and *alters the distribution method to a form that does not qualify for the exception* prior to attainment of age 61, the additional tax will be imposed on amounts distributed prior to age 59½ as if the exception had not applied.[8] (Emphasis added.)

3. *Certain changes to account balance.* A modification to the series of payments will occur if, after the date SEPPs are first calculated, there is (a) any addition to the account balance other than gains or losses, (b) any nontaxable transfer of a portion of the account balance to another retirement plan, or (c) a nontaxable rollover by the taxpayer of the amount received.

   Observation. The Service has taken the position in Rev. Rul. 2002-62 that any nontaxable rollover (even a rollover of the entire account balance) will result in a modification, and that a nontaxable transfer of a *portion* of the account balance will result in a modification. The revenue ruling is silent on whether a nontaxable transfer of the *entire* account balance will result in a modification. This suggests that the Service might be of the view that a nontaxable trustee-to-trustee transfer of the entire account balance (*e.g.*, from one IRA to another IRA) *will not* result in a modification to a series of payments if the SEPPs continue after the transfer,[9] and yet a nontaxable rollover of the entire interest (*e.g.*, from a section 403(b) contract to an IRA) *will* result in a modification even if SEPPs continue after the rollover.[10]

   It should be noted, however, that the Service has concluded in at least two private letter rulings that an inadvertent rollover by a financial institution or IRA custodian of amounts into an IRA from which SEPPs were being made did not result in a modification for purposes of the Recapture Rule.[11] In another private letter ruling, the Service concluded that a partial transfer between two IRAs from which SEPPs were being paid did not result in a modification under the Recapture Rule where the transfer was made by the IRA custodian, without informing the IRA owner, to correct erroneous distributions previously made by the custodian (which also were not treated as modifications to the SEPPs).[12]

Also, the Tax Court in *Benz v. Commissioner*[13] held that a distribution that satisfies the exception to the 10 percent penalty tax for higher education expenses under section 72(t)(2)(E) did not cause a modification to a series of SEPPs where the method of calculating the SEPPs did not change as a result of the additional distribution. In so holding, the Tax Court reasoned as follows:

- An employee may qualify for more than one statutory exception to the 10 percent additional tax. In particular, the last sentence of section 72(t)(2)(E) provides generally that the amount of distributions attributable to higher education expenses does not take into account distributions described in the SEPP Exception.[14] The court explained that if a distribution qualifies for both the SEPP Exception and the section 72(t)(2)(E) exception for higher education expenses, the employee is exempt from the 10 percent penalty tax on the basis of the SEPP Exception, and need only rely on the higher education expense exception for the additional amount of the distribution.

- Citing the legislative history of the SEPP Exception, noted above, the Tax Court stated that a "modification occurs for purposes of section 72(t)(4) when the method of determining the periodic payments changes to a method that no longer qualifies for the exception." In the *Benz* case, the method of calculating the periodic payments did not change as a result of the additional distributions for higher education expenses. The court explained that Congress enacted the Recapture Rule to apply to prior distributions received under a series of periodic payments "where the employee fails to adhere to the payment schedule elected for at least 5 years."[15] The court added that "[t]here is no indication that Congress intended to disallow all additional distributions within the first 5 years of the election to receive periodic payments."[16]

- The Tax Court observed generally that the legislative purpose of the 10 percent penalty tax under section 72(t) is to discourage premature distributions that frustrate the goal of encouraging saving for retirement. The court found that this legislative purpose "is not frustrated where an employee receives distributions for more than one of the purposes that Congress has recognized as deserving special treatment."

In addition, the Service has issued a number of private letter rulings that take a taxpayer-friendly view of whether modifications to a series of SEPPs has occurred. For example, the Service has ruled in at least two private letter rulings that where an individual was receiving distributions from an IRA that satisfied the SEPP Exception at the time of the individual's divorce, the transfer to the individual's spouse of an interest in the IRA pursuant to the divorce judgment constituted a nontaxable transfer, and the resulting reduction in the SEPPs did not constitute a modification to the series of SEPPs under the Recapture Rule.[17] Also, as is relevant for purposes of PLR 201051025, discussed below, the Service has concluded in several instances that the inadvertent failures to make scheduled SEPP distributions that were not caused by the taxpayer (such as failures on the part of a financial institution, custodian or investment advisor), and the subsequent corrective distributions, did not result in modifications of the series of SEPPs that would trigger the application of the Recapture Rule.[18]

PLR 201051025

The taxpayer in PLR 201051025 was under age 59½ and owned an IRA. The taxpayer established an arrangement with the IRA custodian under which the taxpayer would receive distributions in the form of SEPPs intended to comply with the section 72(t)(2)(A)(iv) SEPP Exception. The amount of the annual distribution under the SEPP Exception, calculated using the fixed amortization method, was Amount 1. The taxpayer directed the custodian to distribute Amount 1 in a single lump sum in Year 1 and in equal monthly installments of Amount 2 thereafter. It is unclear whether the single lump sum distribution in Year 1 was made in the same payment interval as the subsequent monthly payments commencing in Year 2 (*i.e.*, whether the lump sum payment in Year 1 might have been paid more or less than one month prior to the first monthly distribution in Year 2).

In Year 6, the IRA custodian failed to make the 12 scheduled monthly payments of Amount 2, and instead distributed only 11 monthly payments. The taxpayer first learned of this when he noticed that the Form 1099-R for Year 6 that he received from the custodian in Month 3 of Year 7 reported the total amount of distributions for Year 6 equal to only 11 monthly payments of Amount 2, rather than the annual distribution amount of Amount 1. The taxpayer proposed to address this failure by receiving an extra, "make-up" payment of Amount 2 in Year 7.

The taxpayer requested the Service to rule that the fact that the amount of the annual payment computed pursuant to the SEPP Exception (Amount 1) was paid in a single sum in Year 1 and in monthly installments beginning in Year 2 would not be considered a modification to the series of SEPPs. In addition, the Service was asked to rule that the failure to distribute the entire required distribution amount for Year 6, and the proposed make-up distribution for Year 7, would not be considered a modification to the series of SEPPs.

The Service concluded that the failure to distribute the entire required annual payment (Amount 1) for Year 6, and the subsequent make-up distribution in Year 7 would not be considered a modification to the series of SEPPs under the Recapture Rule. This conclusion is not surprising given that the Service has taken a similar position in a number of other instances. As noted above, the Service has concluded in several private letter rulings that the failure to distribute the entire required annual payment amount from an arrangement for a stated calendar year, and the subsequent corrective distribution, did not result in a modification for purposes of the Recapture Rule where the individual taxpayer did all he could in order to ensure that the SEPPs would be distributed, and the inadvertent failure to make the proper distributions was caused by a financial institution, custodian or investment advisor.[19]

The novel aspect of PLR 201051025 is the second ruling, in which the Service concluded that the fact that the amount of the annual payment (Amount 1) was paid in a single sum in Year 1 and in monthly distributions beginning in Year 2 would not be considered a modification to the series of SEPPs under the Recapture Rule. This appears to be the

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first instance in which the Service has addressed whether a change from an annual payment to monthly payments constitutes a modification of SEPPs. The private letter ruling does not provide the Service's rationale for reaching this conclusion. It does indicate, however, the Service's willingness to apply the SEPP Exception by considering the distributions made on a calendar year basis.

This is not to suggest that the total annual amount of SEPP distributions for a calendar year can be made any time or in any installments during the year. The Service has long been of the view that SEPPs must be part of a scheduled stream of payments in order to qualify for the SEPP Exception.[20] In PLR 201051025, the stream of payments included the scheduled single lump payment of Amount 1 in Year 1, followed by the scheduled monthly payments of Amount 2 beginning in Year 2.

> ***Observation.*** It appears that the Service applied the SEPP Exception in PLR 201051025 by considering the payments made on a calendar year basis, rather than by looking at each distribution in the series of payments. Consistent with this observation, the Service did not make an issue of the fact that the IRA custodian in PLR 201051025 distributed the incorrect amount for Months 1 and 2 of Year 2, and subsequently made a corrective distribution (apparently in Year 2). Also, the taxpayer did not request a ruling addressing whether these incorrect payments, and the corrective distribution, resulted in a modification to the series of SEPPs.

CONCLUSION

PLR 201051025 is noteworthy because it demonstrates that the Service will in some cases overlook certain deviations in a stream of SEPPs for purposes of applying the SEPP Exception and the Recapture Rule. The private letter ruling (1) is consistent with the position taken by the Service in other private letter rulings that certain inadvertent failures to make SEPP distributions will not result in modifications under the Recapture Rule, and (2) addressed a situation in which a lump sum payment that is different in amount (and possibly timing) from the following periodic distributions nevertheless was viewed as part of a series of SEPPs. These conclusions reflect the Service's willingness to look beyond a strict reading of the Code, the legislative history, and Rev. Rul. 2002-62 in applying the SEPP Exception and the Recapture Rule. ◀

END NOTES

1 Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

2 2002-42 I.R.B. 710, *modifying* Q&A-12 of Notice 89-25, 1989-1 I.R.B. 68.

3 It should be noted that a private letter ruling (or "PLR") may not be used or cited as precedent, and may be relied on only by the taxpayer to whom it is issued. *See* sections 6110(k)(3) and 6110(b)(1)(A).

4 For this purpose, the term "qualified retirement plan" is defined in section 4974(c) to include (1) a qualified plan under section 401(a); (2) an annuity plan described in section 403(a); (3) a section 403(b) annuity contract; (4) an IRA account under section 408(a); and (5) an IRA annuity described in section 408(b).

5 Form 1099-R (*Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.)* is used to report distributions from profit-sharing or retirement plans, IRAs, annuities, pensions, insurance contracts and certain other instruments. The 2011 Instructions for Forms 1099-R and 5498 provide that distribution code 1 (Early distribution, no known exception) must be input into box 7 of a Form 1099-R that reports a distribution made before the employee/taxpayer attains age 59½ if the payor cannot determine whether an exception to the 10 percent penalty tax applies with respect to the distribution. Distribution code 2 (Early distribution, exception applies) must be input into box 7 of a Form 1099-R that reports a distribution made before the employee/taxpayer attains age 59½ if it can be determined that an exception to the 10 percent penalty tax applies with respect to the distribution. Consistent with the Recapture Rule, the instructions explain that even if the employee/taxpayer has attained age 59½, distribution code 2 should be used if a series of SEPPs is modified within five years of the first payment (within the meaning of section 72(q)(3) or (t)(4)) where distributions in previous years were reported using distribution code 2.

6 S. Rep. No. 99-313, at 615 (1986); Staff of the J. Comm. On Tax'n, 99th Cong., General Explanation of the Tax Reform Act of 1986, at 717 (J. Comm. Print 1987).

7 Staff of the J. Comm. On Tax'n, 97th Cong., General Explanation of the Tax Equity and Fiscal Responsibility Act of 1982, at 364 (J. Comm. Print 1982). *See also* PLR 200818018 (Jan. 29, 2008) (finding that variable payments determined under a method that was actuarially equivalent to the method of withdrawing a constant number of annuity units described in the TEFRA Blue Book produced a series of SEPPs within the meaning of section 72(u)(4)(C)).

8 H. R. Rep. No. 99-841 (Vol. II), at II-457 (1986). *See also* H. R. Rep. No. 99-841 at II-403 (providing the same explanation with respect to the SEPP Exception under section 72(q)(2)(D)).

9 *See, e.g.,* PLR 200929021 (Apr. 21, 2009).

10 *See* PLR 200616046 (Jan. 27, 2006) (concluding that SEPPs from an IRA were not modified where they continued after what appears to be a complete trustee-to-trustee transfer to another IRA, but which was described as a "roll over" of the IRA funds "in their entirety").

11 *See, e.g.,* PLR 200929021; PLR 200616046.

12 PLR 200628029 (Apr. 17, 2006).

13 132 TC 330 (2009).

14 The court noted that the exceptions to the 10 percent penalty tax under section 72(t)(2)(B) (relating to distributions for medical expenses), and section 72(t)(2)(f) (relating to distributions for first home purchases) include similar provisions. Id. at 335.

15 *Id.*

16 *Id.*

17 *See*, e.g., PLR 201030038 (May 5, 2010); PLR 200717026 (Feb. 1, 2007).

18 *See, e.g.,* PLR 200930053 (Apr. 27, 2009); PLR 200840054 (July 8, 2008); PLR 200835033 (June 3, 2008); PLR 200503036 (Oct. 25, 2004).

19 *Id.*

20 *See, e.g.,* PLR 9146008 (Aug. 8, 1991) (concluding that in order for systematic withdrawals from a non-qualified annuity contract to qualify as distributions that are part of a series of SEPPs under the section 72(q)(2)(D) SEPP Exception, the withdrawals must be received as part of a "scheduled" series of substantially equal periodic payments over a duration not less than the life expectancy of the taxpayer).