Gee v. Commissioner of Internal Revenue, 127 T. C. 1 (U. S. Tax Ct. 2006)

In Gee v. Commissioner, the U. S. Tax Court ruled that a distribution from an IRA, which had been funded by a rollover from a deceased spouse's IRA, was subject to a 10% additional tax under IRC section 72(t). The court clarified that once funds are rolled over into a surviving spouse's own IRA, they lose their character as a distribution upon the decedent's death. This decision impacts how beneficiaries handle inherited IRA funds, reinforcing the tax implications of managing such assets within personal retirement accounts.

Parties

Charlotte and Charles T. Gee, petitioners, contested a deficiency and penalty determination by the Commissioner of Internal Revenue, respondent, in the U. S. Tax Court.

Facts

Charlotte Gee inherited her husband Ray A. Campbell, Jr. 's IRA upon his death in 1998. She rolled over the full balance of his IRA into her own pre-existing IRA. In 2002, Charlotte, then under age 59 1/2, withdrew $977,887. 79 from her IRA. The Gees did not report or pay the 10% additional tax on this early distribution, claiming it was exempt because the funds originated from her deceased husband's IRA.

Procedural History

The Commissioner issued a notice of deficiency to the Gees, determining a $97,789 deficiency for 2002 and an accuracy-related penalty under IRC section 6662(a). The Gees timely filed a petition with the U. S. Tax Court contesting these determinations. The case was submitted fully stipulated under Tax Court Rule 122, with no trial held.

Issue(s)

1. Whether a distribution from Charlotte Gee's IRA, funded in part by a rollover from her deceased husband's IRA, is subject to the 10% additional tax on early distributions under IRC section 72(t)?

2. Whether the Gees are liable for the accuracy-related penalty under IRC section 6662(a) for a substantial understatement of income tax?

Rule(s) of Law

IRC section 72(t) imposes a 10% additional tax on early distributions from qualified retirement plans, including IRAs, unless an exception applies. One exception, under section 72(t)(2)(A)(ii), exempts distributions made to a beneficiary on or after the death of the employee. Treasury Regulation section 1. 408-8, Q&A-5 and 7, states

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that a surviving spouse who rolls over a deceased spouse's IRA into their own IRA becomes the owner of the new IRA for all Code purposes.

Holding

1. The court held that the distribution from Charlotte Gee's IRA was subject to the 10% additional tax under IRC section 72(t). The funds lost their character as a distribution upon the decedent's death once rolled over into her own IRA.

2. The court held that the Gees were not liable for the accuracy-related penalty under IRC section 6662(a), finding they acted reasonably and in good faith.

Reasoning

The court reasoned that once Charlotte rolled over her deceased husband's IRA funds into her own IRA, she became the owner of those funds for all purposes of the Code. The court rejected the argument that the funds retained their character as a distribution upon the decedent's death, emphasizing that the distribution was not occasioned by the death of her husband nor made to her as a beneficiary of his IRA. The court found that Charlotte could not have it both ways – rolling over the funds into her own IRA and then claiming the distribution was exempt from the additional tax because it originated from her deceased husband's IRA. The court noted the purpose of the section 72(t) tax is to discourage premature IRA distributions that frustrate retirement savings goals. The court also considered the lack of prior cases directly addressing this issue and found the Gees' position was a reasonable attempt to comply with the Code in a novel circumstance, thus excusing them from the accuracy-related penalty.

Disposition

The court entered a decision for the Commissioner with respect to the deficiency and for the Gees with respect to the penalty under IRC section 6662(a).

Significance/Impact

This case clarifies that a surviving spouse who rolls over a deceased spouse's IRA into their own IRA cannot later withdraw funds and claim the distribution is exempt from the 10% additional tax on early distributions. It underscores the importance of the choice between rolling over inherited IRA funds or maintaining them as a separate inherited IRA. The decision also highlights the Tax Court's willingness to excuse penalties in cases involving novel legal issues where taxpayers act reasonably and in good faith. This ruling impacts estate planning and retirement account management strategies for surviving spouses.

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