T.C. Memo. 2009-169

Distributions from an IRA for qualified higher education expenses do not constitute an impermissible modification of a series of substantially equal periodic payments (SEPPs) and are not subject to the 10% early withdrawal penalty, even if taken within five years of initiating SEPPs.

Summary

The Tax Court held that additional distributions from an IRA, used for qualified higher education expenses, did not violate the substantially equal periodic payments (SEPP) rules under Section 72(t) of the Internal Revenue Code. The petitioner had initiated SEPPs and, within five years, took additional distributions for her son's college expenses. The IRS argued these extra distributions triggered a retroactive penalty on the initial SEPPs. The court disagreed, finding that the higher education expense exception under Section 72(t)(2)(E) is independent of the SEPP exception and does not constitute a modification of the payment series. This ruling allows taxpayers to utilize both SEPP and higher education exceptions without penalty.

Facts

Petitioner wife began receiving substantially equal periodic payments (SEPPs) from her IRA in January 2002 after leaving her employment. The annual distribution was fixed at $102,311.50. In 2004, within five years of starting SEPPs and before age 59 1/2, she received three IRA distributions: the scheduled SEPP of $102,311.50, and two additional distributions of $20,000 and $2,500. The additional $22,500 was used for qualified higher education expenses for her son. Petitioners did not report an early withdrawal penalty on their 2004 tax return for any of the distributions.

Procedural History

The IRS issued a notice of deficiency for 2004, asserting an $8,959 penalty. The IRS argued that the $89,590 of the IRA distributions (total distributions minus the conceded higher education expense amount of $35,221.50) was subject to the 10% early withdrawal tax because the additional distributions constituted a modification of the SEPP arrangement. The petitioners contested this deficiency in Tax Court.

Issue(s)

1. Whether distributions from an IRA for qualified higher education expenses, taken while receiving substantially equal periodic payments (SEPPs) and within five years of commencing SEPPs, constitute a modification of the SEPP arrangement under Section 72(t)(4) of the Internal Revenue Code, thereby triggering the early withdrawal penalty on prior SEPP distributions.

Holding

1. No. The Tax Court held that a distribution qualifying for the higher education expense exception under Section 72(t)(2)(E) is not a modification of a series of substantially equal periodic payments. Therefore, the additional distributions for higher education did not trigger the recapture tax under Section 72(t)(4).

Court's Reasoning

The court reasoned that Section 72(t)(2)(E) provides an independent exception to the early withdrawal penalty for higher education expenses, separate from the SEPP exception in Section 72(t)(2)(A)(iv). The court emphasized that the last sentence of Section 72(t)(2)(E) states that higher education distributions are considered separately from distributions described in subparagraph (A) (which includes SEPPs), (C), or (D). This indicates Congressional intent to allow taxpayers to utilize multiple exceptions. The court quoted legislative history stating Congress recognized "it is appropriate and important to allow individuals to withdraw amounts from their iras for purposes of paying higher education expenses without incurring an additional 10-percent early withdrawal tax." The court distinguished *Arnold v. Commissioner*, 111 T.C. 250 (1998), noting that *Arnold* involved a distribution that did not qualify for any exception, whereas in this case, the distributions specifically qualified for the higher education exception. The court concluded that taking distributions for a purpose Congress specifically exempted does not frustrate the legislative intent of discouraging premature retirement savings withdrawals, as long as the SEPP payment method itself remains unchanged.

Practical Implications

This case clarifies that taxpayers receiving SEPPs from IRAs can still access funds for qualified higher education expenses without triggering the retroactive early withdrawal penalty, even within the initial five-year period of SEPPs and before age 59 1/2. It confirms that the higher education expense exception under Section 72(t)(2)(E) operates independently of the SEPP rules. This provides greater flexibility for taxpayers needing to fund higher education while relying on SEPPs for income. Legal practitioners should advise clients that utilizing the higher education exception will not be considered a modification of SEPPs. This case is significant for retirement planning and IRA distribution strategies, particularly for individuals facing higher education expenses.

