Penalty on Early IRA Withdrawals

by Neil E. Harl

Since their authorization in 1974, individual retirement accounts have enjoyed astounding growth. In total, IRAs have more than $3 trillion in assets and are held by more than 45 percent of U.S. households. Roughly 26 percent of the $11.6 trillion U.S. retirement asset market is held in individual retirement accounts. Assets held in IRAs have increased 13 percent per year since 1990.

As is well known, contributions are deductible within limits ($4,000 in 2005 with additional “catch-up” contributions by those age 50 and older). And, growth in the fund is tax-free until funds are withdrawn. However, a veritable flood of cases and rulings in recent months has focused attention on the tax consequences of early withdrawal.

General rule

Distributions to the owner of a traditional IRA generally must begin no later than April 1 following the calendar year in which the owner reaches age 70 ½. However, distributions can be delayed beyond 70 ½ until April 1 of the calendar year after an employee retires if the employee is not a “five percent” owner. A “five percent” owner is defined as someone who owns more than five percent of the total combined voting power or the capital or profits interest of the employer.

Distributions from a traditional IRA to a participant before that individual reaches age 59 ½ are generally subject to the same 10 percent penalty (plus regular income tax, of course) that apply to early distributions from other types of qualified plans. However, there are numerous exceptions – and that’s where taxpayers have often run into problems.

First, a distribution on or after the death of a participant is not subject to the 10 percent penalty. Moreover, a distribution because of disability of the participant is not subject to the penalty.

Distributions made for an employee after separation from service after reaching age 55 are not subject to the penalty for qualified plans but that exception does not apply to IRAs.

Distributions for higher education expenses incurred in the taxable year of the distribution are not subject to the 10 percent penalty. The expenses can be incurred for the individual, the individual’s spouse, child or grandchild of the individual or the individual’s spouse. A case decided on July 5, 2005, by the Tax Court held that IRA distributions used to pay education expenses incurred in the year before the distribution were subject to the 10 percent additional tax. And a Tax Court case decided on July 19, 2005, pointed out that

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* Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.
an IRA distribution used to pay qualified higher education expenses in the year after the distribution was subject to the 10 percent penalty.\textsuperscript{18}

Limited distributions for first time home purchases are an exception from the penalty.\textsuperscript{19} To be considered a first time home buyer, the individual (and spouse if the individual is married) must not have had an ownership interest in a principal residence during the two-year period ending on the date the new home is acquired.\textsuperscript{20} Qualified expenses include acquisition costs, settlement charges and closing costs.\textsuperscript{21} The residence may be for the individual or the individual’s spouse, child, grandchild or ancestor of the individual or the individual’s spouse.\textsuperscript{22} Only $10,000 during the individual’s lifetime may be withdrawn without a penalty for this purpose.\textsuperscript{23}

Distributions to unemployed individuals for health insurance premiums are not subject to the 10 percent penalty.\textsuperscript{24} That’s if the individual has received unemployment compensation for 12 consecutive weeks under any federal or state unemployment compensation law and the distributions are made during the year unemployment compensation is paid or the succeeding taxable year and the distributions do not exceed the amount paid for insurance.\textsuperscript{25}

Distributions for expenses paid for medical care are an exception to the 10 percent penalty, also.\textsuperscript{26} That’s to the extent the distributions do not exceed the medical deduction.\textsuperscript{27}

There’s also an exception for distributions which are part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the individual or the joint lives of the individual and the designated beneficiary.\textsuperscript{28} If it involves a qualified plan, the exception does not apply until the individual separates from service.\textsuperscript{29} The major issue is whether the individual can continue to work in some capacity for the employer. Generally, the individual must change status (from an employee to an independent contractor, for example), and render services on an irregular basis although in some cases a shift in status alone has not been sufficient.\textsuperscript{30}

There’s an exception from the 10 percent penalty for payments under a Qualified Domestic Relations Order but that does not apply to IRAs.\textsuperscript{31}

\textbf{Other situations}

In one recent case, the court said bankruptcy filing did not excuse an early withdrawal.\textsuperscript{32} The bankruptcy estate apparently takes over the debtor’s age and thus is liable for the premature distribution penalty.\textsuperscript{33} In a 2004 case, withdrawal because of economic hardship and to avoid foreclosure on the home were not considered exceptions and the 10 percent penalty was imposed.\textsuperscript{34}

A 2003 case involved an involuntary distribution from the account as a result of an IRS levy.\textsuperscript{35} The amount involved was included in income of the recipient but the 10 percent penalty for early withdrawal was not assessed.\textsuperscript{36}

\textbf{In conclusion}

Any distribution before age 59 ½ should be planned very carefully. Most of the cases thus far have involved situations where the decision to withdraw apparently was made without much tax advice and counsel.

\textbf{FOOTNOTES}


2 Id

3 Id.

4 I.R.C. § 219(b)(5).


6 See, e.g., notes 17-18 infra.

7 I.R.C. § 401(a)(9)(C).

8 Id.

9 I.R.C. § 416(i)(1)(B)(I – this is a lower case eye).

10 I.R.C. § 72(t).


14 I.R.C. § 72(t)(3).

15 I.R.C. § 72(t)(2)(E). See Gorski v. Comm’r, T.C. Summary Opinion 2005-112 (expenditures for computer, housewares, furniture, appliances and bedding were not qualified expenses for purposes of 10 percent additional tax on IRA distribution; expense for course books not excluldeable because not substantiated).

16 I.R.C. § 72(t)(7)(A).


21 I.R.C. § 72(t)(8)(C).


24 I.R.C. § 72(t)(2)(D).

25 Id.


27 Id.


30 Rev. Rul. 69-647, 1969-2 C.B. 101 (senior executive who retired from full-time employment and continued to render services on a part-time basis as consultant was considered to
have separated from employment). See Reinhardt v. Comm’r, 85 T.C. 511 (1985) (employee-shareholder who sold equity interest in corporation and changed from employee to independent contractor but continued to perform same services did not “separate from service”); Bolden v. Comm’r, 39 T.C. 829 (1963) (no separation from service for former shareholder-employee who continued after sale of equity interest in advisory capacity); Ridenour v. United States, 3 Ct. Cl. 128 (1983) (individual who continues to provide services has not separated from service even though status may have changed); Rev. Rul. 81-26, 1981-

1 C.B. 200 (employee who became partner not separated from employment).


33 In re Kochell, 804 F.2d 84 (7th Cir. 1986).


36 Id.

CASES, REGULATIONS AND STATUTES by Robert P. Achenbach, Jr

ADVERSE POSSESSION

HOSTILE POSSESSION. The disputed land was on the plaintiff’s side of a fence which was located on the defendant’s property. The surveys showed the defendant’s land to extend past the fence by about 15 feet. The plaintiff claimed title to the disputed land by adverse possession, claiming to have used the disputed strip for some crops, a walking path, and for a road. The defendant argued that the plaintiff’s use was occasional and not sufficiently hostile to cause title to pass by adverse possession. The trial court held for the defendant and the appellate court affirmed, holding that the evidence, at best, showed only occasional use of the disputed land by the plaintiff and no actions which would necessarily put the defendant on notice that the plaintiff was using the land as the plaintiff’s own. The court noted, for example, that the “road” was little more than a path and showed no signs of tire marks or ruts. Groves v. Applen, 2005 Wash. App. LEXIS 1460 (Wash. Ct. App. 2005).

BANKRUPTCY

GENERAL

EXCEPTIONS.

HOMESTEAD. The debtors, husband and wife, used the proceeds of nonexempt assets to prepay for the construction of an addition to their residence. The construction contract was entered into and the deposit paid for the entire cost of the construction after a judgment was entered against the debtors but before an involuntary Chapter 7 case was filed against the debtors. The judgment creditors sought to recover the deposit payment and the debtors sought to include the deposit in the homestead exemption. Construction commenced soon after the bankruptcy petition was filed but before the order for relief was issued. The court held that, upon the signing of the contract and payment of the construction costs, the payment was equitably converted into part of the residence and became eligible for part of the residence exemption. In re Hodes, 402 F.3d 1005 (10th Cir. 2005), aff’g, 287 B.R. 561 (D. Kan. 2002).

IRA. The debtor was divorced and the divorce decree provided for alimony payments to the debtor’s spouse. The divorce decree also provided that the alimony payments were secured by the debtor’s interest in an employee retirement account. The debtor failed to make the alimony payments and the former spouse sued to enforce the divorce decree against the retirement account. The debtor filed for bankruptcy and claimed the retirement account as exempt and the security interest as void as against an anti-assignment statute. The court held that the retirement account was not governed by the anti-assignment provision under Texas law which exempted alimony. In addition, the court held that the divorce decree security interest was deemed a distribution at the time of the decree, removing the pledged funds from the retirement account. Therefore, the pledged funds were not eligible for the retirement funds exemption. In re Coppola, 2005-2 U.S. Tax Cas. (CCH) ¶ 50,503 (5th Cir. 2005).

CHAPTER 12

ELIGIBILITY. The debtors had borrowed operating funds from a Farm Credit Services bank for their mint farm but defaulted on the loan and had to file Chapter 7 bankruptcy. In that bankruptcy case, the debtors received a discharge of unsecured loans, including the portion of the bank loan above the value of the farm. After the loan default, the debtors leased the farmland under cash and share leases. The leases required the debtors to maintain irrigation equipment, often on a daily basis. The debtors filed another Chapter 12 case and the bank objected to the debtors’ eligibility for Chapter 12 because (1) the debtor’s debts exceeded the $1.5 million limit and (2) the debtors were not engaged in farming. The bank argued that the full amount of the unpaid loan should be included in the debtor’s debts, not just the portion secured by the fair market value of the farm. The court held that the unsecured portion of the loan was discharged in the previous Chapter 7 case and was no longer a personal obligation of the debtors; therefore, the unsecured portion discharged in the Chapter 7 case was not included in the debts for purposes of eligibility for Chapter 12. The court also held that the debtors were engaged in farming because most of the leases were sharecrop leases and the debtors were required to maintain a substantial involvement