Anthony P. Curatola, Editor

Self-Employed and IRA Early Distribution

While the U.S. government provides incentives within income tax regulations to encourage taxpayers to save for retirement, it also recognizes that situations in life arise where that money may be needed before retirement. One such situation is a distribution to unemployed individuals for health insurance premiums. As with most exceptions, the proper conditions must be satisfied to avoid an early-withdrawal penalty.

Individuals are keenly aware of the need to have money and assets set aside so they can enjoy their current lifestyle throughout retirement. Federal—and, in many cases, state—income tax laws encourage saving for retirement by providing favorable tax treatment for investments made and earnings accrued in qualified retirement plans, including Individual Retirement Accounts (IRAs).

Congress not only provides tax incentives to encourage saving for retirement, but it also provides tax disincentives for taking early distributions of these savings before retirement except under special circumstances. The federal penalty for the early removal of these savings is 10% on the total taxable amount of the withdrawn amount. In addition to the 10% penalty, the taxable withdrawal amount generally is included in gross income, which could be subject to as much as another 35% of income tax. On top of the federal taxes accruing to the distributed amount, a person is likely to incur state income tax or even state early distribution penalties on the same amount. Thus, a person really needs to evaluate the value of taking an early distribution from retirement accounts.

Example. Rhoda needs $8,000 to settle an outstanding account and decides to withdraw the money from her IRA. Because Rhoda is in the 25% tax bracket and needs to have $8,000 remaining after paying all federal taxes, she needs to withdraw $12,308 from her IRA. The $12,308 is computed as $8,000/(1 – 0.1 – 0.25). The 0.1 is the 10% withdrawal penalty, and the 0.25 is the 25% marginal tax rate. By withdrawing $12,308, Rhoda incurs $1,231 ($12,308 × 10%) in early distribution tax and $3,077 ($12,308 × 25%) in federal income tax.

Since the enactment of the early distribution excise tax, Congress has recognized that there are financial events that arise during an individual's life that may necessitate (or compel) the use of his or her retirement savings. Hence, Congress has modified this excise tax to permit nonpenalized distributions for specific nonretirement reasons. There were initially seven exceptions, but the number has grown to more than a dozen over the past few years. One of the exceptions added after the original seven pertains to distributions to unemployed individuals for health insurance premiums (IRC §72(t)(2)(D)).

IRC §72(t)(2)(D) provides, in part, that a distribution from an IRA to an individual after separation from employment isn't subject to the 10% penalty if the individual satisfies three conditions:

1. The individual has received unemployment compensation under federal or state law for at least 12 weeks.
2. The withdrawal is made in the year or following year of such unemployment.
3. The exempted withdrawal amount is limited to the amount paid during the taxable year for health insurance (IRC §213(d)(1)(D)) with respect to the individual, spouse, and dependents.

Example: In the previous example, Rhoda needed to withdraw

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$12,308 from her IRA in order to have $8,000 to settle an outstanding account after paying the federal taxes. If Rhoda were qualified under the unemployment exception, she would only need to withdraw $10,667 from her IRA. The $10,667 is computed as $8,000/(1 – 0.25). By withdrawing $10,667, Rhoda incurs $2,667 ($10,667 × 25%) in federal income tax.

The availability of the exception is further broadened by IRC §72(t)(2)(D)(iii), which permits self-employed individuals to take a withdrawal without incurring the 10% penalty for health insurance payments. The catch, if you will, is that the self-employed must satisfy an additional hurdle. To the extent provided in regulations, a self-employed individual shall be treated as receiving unemployment compensation for at least 12 weeks if, under federal or state law, the individual would have received unemployment compensation but for the fact the individual was self-employed.

To date, there are no regulations to provide guidance on how to satisfy this hurdle. Recently, the IRS chief counsel issued CCA 200920052 (April 8, 2009) on this issue, which states, "If the taxpayer is self-employed, the taxpayer has to present evidence that he would have been eligible to receive any Federal or State unemployment compensation, but for the fact that the taxpayer was self-employed." In addition, chief counsel references the Tax Court Summary Opinion 2005-78 (July 8, 2005) on how the Tax Court handled an S case dealing with this tax provision. Of course, a Tax Court Summary Opinion can't be cited as precedence, so the opinion is informative but lacks authority for other taxpayers.

In essence, the court ruled that the taxpayer failed to provide evidence that he would have been eligible to receive any federal or state unemployment compensation. In fact, the taxpayer by his own testimony applied for unemployment compensation but was informed by the State of California that he wasn't eligible because he hadn't worked for a specified period. You might argue that an individual being turned down for unemployment because he or she is self-employed has one piece of evidence for satisfying the 10% early withdrawal penalty exception. The taxpayer, however, should be prepared to offer additional evidence showing that he or she otherwise would qualify and is unemployed.

There is yet another matter to be aware of with respect to this issue. Any distributions made from the IRA after the individual is reemployed for at least 60 days will be subject to the 10% penalty pursuant to IRC §72(t)(2)(D)(ii). Therefore, once a person is reemployed, he or she remains eligible to take advantage of this exception for 59 days.

Although this area is quite relevant in today's economic climate, it's also apparent that this provision may be theoretically available for self-employed individuals but may not be practically available. Thus a self-employed taxpayer should be leery about taking advantage of this provision.

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