**§72(t) Penalty First-Time Home Buyer Exception:
An Analysis of Court Rulings**

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**ABSTRACT**

Individual Retirement Accounts (IRAs) are an important tool in retirement planning; however, early distributions prior to age 59½ can be subject to the §72(t) 10% early distribution penalty (IRC §72(t)). There are several exemptions to the penalty, and this paper looks at the specific exemptions and focuses primarily on the court findings covering § 72(t)(8). The research shows that there are four primary reasons why taxpayers did not qualify for the exemption. Several taxpayers did not qualify as first-time homebuyers since they already had an ownership interest in a principal residence. In one instance, the taxpayer did not qualify because there was no ownership interest in the property the distribution was used to purchase. A few taxpayers failed to meet the exemption because the distribution came from retirement accounts that were not IRAs. The § 72(t)(8) exemption only applies to distributions from IRAs. Other taxpayers failed to meet the requirements for exemption because they did not use the distribution within the 120-day window. The court findings indicate that strict adherence to the law is required for qualification of the exemptions.

**Introduction**

Individual Retirement Accounts (IRAs) are an important tool in retirement planning; however, early distributions prior to age 59½ can be subject to the §72(t) 10% early distribution penalty (IRC §72(t)). There are several exemptions to the penalty including payment of medical insurance premiums by unemployed individuals (IRC §72(t)(2)(D). If the distribution is used to pay for qualified higher education expenses of the individual, the individual’s spouse or child, or a grandchild of the individual or the individual’s spouse, the early distribution penalty does not apply (IRC §72(t)(2)(E). Additionally, a distribution of no more than $10,000 may be used for paying the costs associated with the purchase of a first-time home without being subject to the early distribution penalty (IRC §72(t)(2)(F). In order to qualify for the first-time home buyer exemption, the individual and spouse must not have owned a principal residence in the last two years ending with the date that the new home is purchased. A return of nondeductible contributions is also exempt from the early distribution penalty. What is notably missing from these exemptions is the ability to retire before 59½ and take a series of equal and substantial withdrawals. This was prior law and not included in the provisions of the Tax Cuts and Jobs Act (TCJA).

**Purpose of Study**

The purpose of this study is to examine the court proceedings related to the §72(t) first-time homebuyer exemption and determine what causes taxpayers to fail to meet the exemption.

**Literature Review**

 Eight cases were reviewed related to the § 72(t)(2)(F) first-time home buyer exemption. The time frame of these cases is from 2003–2015. All of these cases were heard in the United States Tax Court. The Commissioner in place changes depending upon the year the case was heard.

**Olup v. Commissioner**

 In Olup v. Commissioner (2005), the taxpayer purchased a home prior to getting married. The taxpayers withdrew $20,617 from the husband’s IRA. The home purchase was the first purchase for the wife but not the first for the husband. The couple reported the $20,617 as taxable income but held that $10,000 of the distribution was not subject to the additional tax on early distributions. The Commissioner determined that the taxpayers were liable for the additional 10% payment since the husband was not a first-time homebuyer under the language of §72(t)(8)(D). Both taxpayers needed to qualify as first-time homebuyers in order to avoid the 10% penalty. The court rejected the couple’s argument that §78(t)(8)(D) should be construed to include the first-time marital residence.

**Ung v. Commissioner**

 In Ung v. Commissioner (2013), the taxpayer claimed that her withdrawal of $20,000 from an IRA qualified for the first-time homebuyer’s exemption since she used the money as a down payment on the “Kam Court” property. However, the court found that she was not the legal owner of the property nor was she able to prove that she was an equitable title owner. No legal documentation existed that conferred title on her; payments for home repairs were not acquiring, constructing, or reconstructing costs within the guidelines of §72(t)(8)(C). She also failed to establish reasonable cause, or that she showed good faith with respect to the underpayment of tax, or that any of the underpayment was due to reasonable cause. The court found that she was liable for the §6662(a) accuracy-related penalty.

**Sharma v. Commissioner**

 In Sharma v. Commissioner (2008), the taxpayers held the position that they qualified as first-time homebuyers. They argued that they did not acquire an interest in their home until the mortgage was paid off on June 4, 2004. They argued that until April 4, 2004, the home was owned by the mortgage company and, accordingly, held no ownership interest in the home. The court disagreed indicating that they held an ownership interest during the two-year period before they received the distribution. The release of the mortgage was simply the release of the lien. While the taxpayers requested the court to construe the statute equitably in their favor, the court had to apply the law as enacted by Congress.

**Jones v. Commissioner (a)**

 In Jones v. Commissioner (2003), the taxpayer participated in his employer’s defined contribution plan which was qualified under §401(a)(k). Employees could elect to make pretax or after-tax contributions. The taxpayer made pretax contributions to his account. Pretax contributions could not be withdrawn from the account before age 59½ unless the participant was terminated or had financial hardship. Employee participants could apply for loans subject to repayment provisions. The taxpayer argued that he qualified for the first-time homebuyer’s exemption, but the court disagreed. The taxpayer failed to qualify as a first-time homebuyer under §72(t)(8)(D)(i)(I). The court found the taxpayer liable for the 10% additional tax.

**Suarez v. Commissioner**

 In Suarez v. Commissioner (2015), the taxpayer withdrew money from his IRA account to pay for the rebuilding costs of a house purchased from the Department of Veterans Affairs. The court held that the taxpayer was liable for the § 72(t) penalty since they were already homeowners. The taxpayers did not argue that the existing home was not their principle residence. The court entered a decision for the Commissioner.

**Jones v. Commissioner (b)**

 In Jones v. Commissioner (2005), the taxpayer received a distribution from his 401k plan and used the proceeds to pay for his first home and school expenses. The court found that the distribution from the 401k plan did not qualify for exemption under § 72(t)(2)(e) and (f) since it was not a distribution from an IRA. The taxpayer argued that, since he could have rolled his 401k into an IRA and the difference between an IRA and a 401k was a matter of form, he qualified for the exemption. This argument did not change the fact that the amount received was not a distribution from an IRA.

**Ambrust v. Commissioner**

 In Ambrust v. Commissioner (2010), the taxpayer was unable to obtain financing for his first-time home purchase due to his low credit rating. His father recorded a deed and obtained a mortgage in the father’s name. The taxpayer reimbursed his father for the closing costs and down payment, and his father executed a quitclaim deed transferring ownership to his son. The taxpayer withdrew the funds from his employer’s retirement plan. At that time, the employer was converting the retirement plan to a 401k plan. The court agreed with the Commissioner that the taxpayer did not qualify for exemption under § 72(t)(2)(F) since the funds were taken from a 401k plan and not from an IRA.

**Smart v. Commissioner**

 In Smart v. Commissioner (2006), the taxpayer received a distribution from his employer’s 401K. He used the proceeds to payoff debt and purchase a first-time home. He took the distribution in 2002, but because his brother died, he did not purchase the home until 2004. The court found that there is no exemption for using the distribution to pay off debts. They additionally found that, since the distribution was not used within the 120-day window under § 72(t)(8), the distribution did not qualify for the exemption. The court found in favor of the Commissioner.

**CONTRIBUTION TO THE LITERATURE**

This paper contributes to the literature by providing a detailed analysis of court findings covering the § 72(t)(8) exemption. The research shows that there are four primary reasons why taxpayers did not qualify for the exemption. Several taxpayers did not qualify as first-time homebuyers since they already had an ownership interest in a principal residence. In one instance, the taxpayer did not qualify because there was no ownership interest in the property the distribution was used to purchase. A few taxpayers failed to meet the exemption because the distribution came from retirement accounts that were not IRAs. The § 72(t)(8) exemption only applies to distributions from IRAs. Other taxpayers failed to meet the requirements for exemption because they did not use the distribution within the 120-day window. The court findings indicate that strict adherence to the law is required for qualification of the exemptions.

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