

By Jerrold J. Stern

penalty-free

IRA WITHDRAWALS FOR HOME PURCHASE

Taxpayers who withdraw funds from IRAs before age 59½ must pay a 10 percent penalty unless they satisfy one of the exceptions. An exception exists for certain homebuyers who qualify as “first-time homebuyers.” They are allowed to withdraw a (lifetime) maximum of \$10,000 penalty-free for the purchase of a home. To use the exception successfully, homeowners must avoid certain pitfalls, as demonstrated by a recent tax court case.

Assume married couple Mary and Jeff began their careers seven years ago and saved a total of \$15,000 for a down payment for their first home. They find a \$175,000 home they want to buy. Because mortgage interest rates are typically higher for mortgages larger than 80 percent of a home’s purchase price, they decide to make a down payment of \$35,000 (20 percent of \$175,000). This leaves them \$20,000 short. Mary and Jeff can make up the difference if each withdraws \$10,000 from an IRA. Under the first-time homebuyer exception, the 10 percent early withdrawal penalty tax would not apply.

A “first-time homebuyer” is defined as anyone who has not owned a home during the prior two years. Thus, a better term might be “not-recent homebuyer.”

Now assume Mary and Jeff are 50-year-old empty nesters. They sold their home and moved into a rental condo two years ago. This year, they decide to buy the condo, but they will need an additional \$20,000 for the down payment. They can withdraw funds from their IRAs (\$10,000 each) without penalty as long as they never before made use of the first-time homebuyer exception, which has a \$10,000-per-taxpayer lifetime maximum.

The 10 percent early withdrawal penalty is avoided even if the \$10,000 is used

to help purchase a home for a “qualified relative,” defined as children, grandchildren, and ancestors of the taxpayer or the taxpayer’s spouse. As a result, a 2013 tax court decision required that the 10 percent penalty be applied to a \$10,000 IRA withdrawal by Laura Ung. Ung used the \$10,000 to pay part of the cost of a home that she and her brother purchased. However, only the brother was listed as the owner on the property deed and residential purchase agreement. Ung lost the case because siblings are not considered

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“qualified relatives,” and she was not a legal owner or co-owner of the property.

“Qualified” uses of the withdrawn IRA funds include costs for acquisition, construction or reconstruction. Closing costs also qualify.

IRAs consist of two types — traditional and Roth. Funds contributed to traditional IRAs are “before-tax” contributions because they are deductible in the year they are made and, thus, lower taxable income and tax liability. However, when traditional IRA funds are withdrawn (and not rolled over to another pension-type account), the funds are fully taxable regardless of the age or other circumstances of the taxpayer.

Returning to the earlier examples, assume the \$20,000 withdrawn by

Mary and Jeff is from traditional IRAs. The

\$20,000 is taxable at their marginal tax rate. If their marginal tax rate is 25 percent, their tax liability increases by \$5,000. The benefit of the first-time homebuyer rule is that the 10 percent penalty for early withdrawal does not have to be paid in addition to the \$5,000. Thus, the couple avoids paying an *additional* \$2,000 (10 percent of \$20,000) to Uncle Sam.

The rules for Roth IRAs differ from those of traditional IRAs. If the IRA is a Roth, withdrawals of up to \$10,000 used to purchase a “first home” are completely free of tax and penalty (as long as the funds have been in the IRA for five years or more). Again, the \$10,000 amount is a lifetime limit. Roth distributions are tax-free because contributions to Roths are made with “after-tax” dollars. The contributions are after-tax because they are not deductible and do not affect tax liability.

Homebuyers who want to use IRA funds for their purchase should pay careful attention to the tax law’s IRA withdrawal rules. For specific advice, consult a tax accountant or tax attorney. 📌

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THE TAKEAWAY

First-time homebuyers and others who qualify may make penalty-free IRA withdrawals to fund the down payment. A recent court case highlights the importance of satisfying all tax law criteria.



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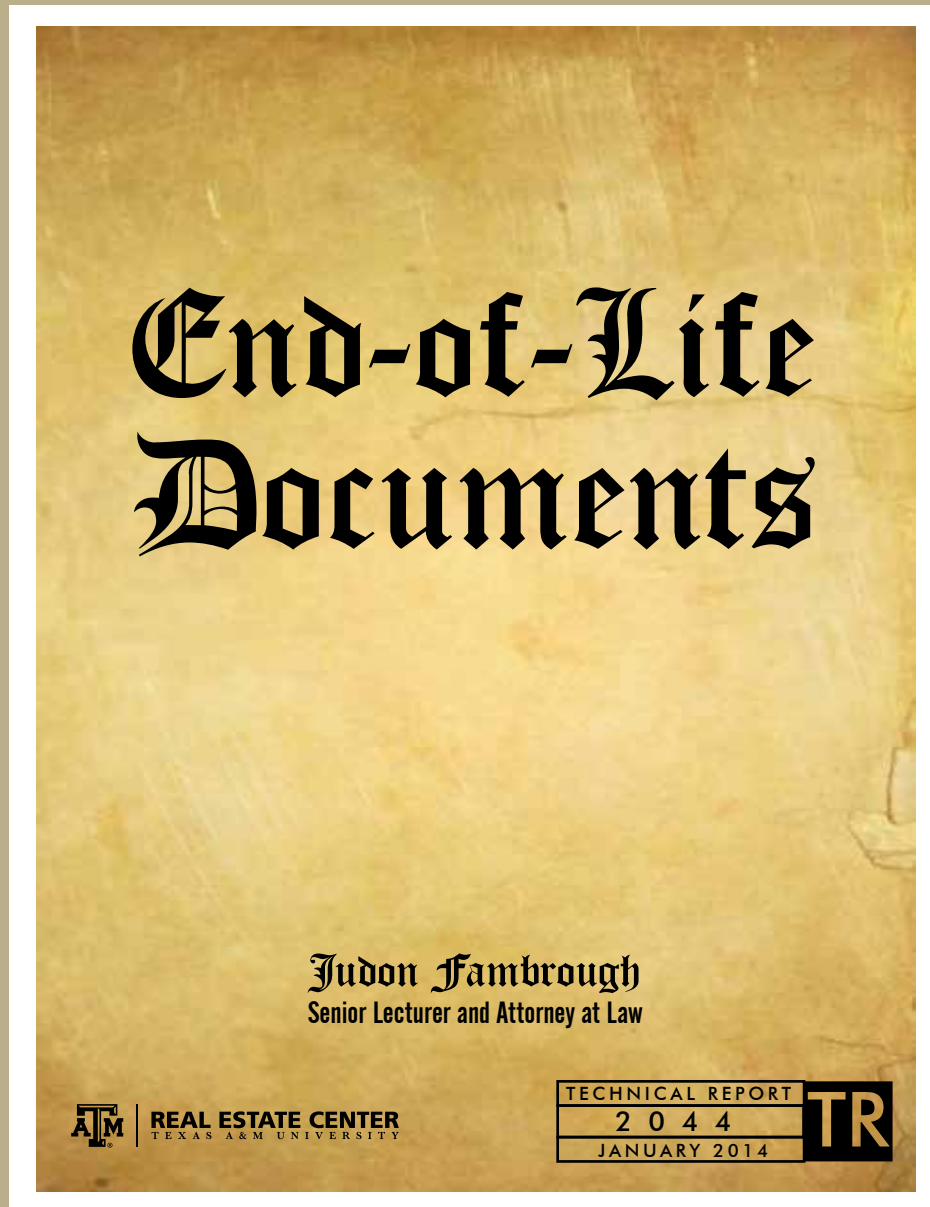


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