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LEGAL ALERT



Legal Alert: IRS Says Tax Rebates May be Withdrawn from Tax-Favored Accounts Without Penalty

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The Internal Revenue Service has announced that individuals who had their “tax rebates” directly deposited into Individual Retirement Accounts (IRA) and other tax-favored accounts may withdraw those “rebate” amounts without liability for either income tax or penalties.

As everyone probably knows by now, most taxpayers are entitled to receive a special “tax rebate” (formally known as an Economic Stimulus Payment, or ESP) based upon their 2007 income, filing status, etc. Most individual filers will receive \$600 (\$1200 for a couple filing a joint return) plus an additional \$600 each dependent child under age 17. For taxpayers whose tax liability is less than the prescribed amount, the ESP is limited to the amount of their tax liability, but not less than \$300/\$600/\$300 so long as certain requirements are met. Finally, the ESP is phased out for taxpayers whose adjusted gross income is over \$75,000 (or \$150,000 on a joint return).

The ESP's are being distributed by check, except for taxpayers who elected on their returns to have a regular tax refund directly deposited to a single designated account of the taxpayer. (If the taxpayer elected to have a regular refund directly deposited into multiple accounts, as is permitted, the ESP will be paid by check, rather than deposit to multiple accounts.) The designated account could be a checking or savings account, but it could also be an IRA, a Health Savings Account (HSA), a Coverdell education savings account, an qualified tuition program (a “529 account”) or an Archer MSA. The problem that has been recognized is that taxpayers who elected direct deposit of their regular refund to a single account may not have intended, or even realized, that their ESPs would be deposited to that same account. In addition, an inadvertent ESP deposit could cause contribution limitations to be exceeded. If the taxpayer simply withdraws the ESP amount from an IRA or other tax-favored account, withdrawals from those accounts are normally taxable income, and may be subject to tax penalties (such as most withdrawals from an IRA prior to age 59½).

In order to resolve this problem, the IRS has announced that directly-deposited ESP amounts may be withdrawn from the enumerated types of tax-favored accounts, without liability for income taxes or penalties on the withdrawal. The withdrawal can be the entire ESP amount (without earnings), or just a portion of the ESP; if only part is withdrawn, the remaining part will be treated as having been contributed to the account on the date of deposit. The withdrawal must be made not later than the due date for the taxpayer's 2008 tax return (normally April 15, 2009, but could be extended),

or in the case of a Coverdell account, May 31, 2009, if later.

Finally, since banks and other financial institutions will not be able to distinguish between a permitted tax-free withdrawal of an ESP and other withdrawals, both the contribution of the ESP and the withdrawal will continue to be reported in the usual manner (for example, on Form 1099-R). Instructions to the 2008 income tax returns will provide the manner in which a tax-free withdrawal should be reported on the return in order to avoid the tax liabilities.

If you have any questions regarding this issue, please contact the author of this Alert, Jeffrey S. Ashendorf, a partner in our New York City office, at jashendorf@fordharrison.com or 212-453-5926, or any member of our Employee Benefits Practice Group.