INVESTMENT COMPANY INSTITUTE

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COURT UPHOLDS CONSTITUTIONALITY OF RETROACTIVE IMPOSITION OF EARLY WITHDRAWAL TAX ON ROTH IRA DISTRIBUTIONS

[12833] November 3, 2000 TO: PENSION COMMITTEE No. 84-00 RE: COURT UPHOLDS CONSTITUTIONALITY OF RETROACTIVE IMPOSITION OF EARLY WITHDRAWAL TAX ON ROTH IRA DISTRIBUTIONS The U.S. Court of Federal Claims recently held that the retroactive imposition of the Code section 72(t) tax on nonqualified withdrawals from Roth IRAs does not violate the Due Process or Takings Clauses of the Fifth Amendment or the Excessive Fines Clause of the Eighth Amendment. Kitt v. United States, 2000 U.S. Claims LEXIS 196 (Sept. 28, 2000). The case arose because of a technical defect in the Roth IRA legislation, which was corrected in subsequent legislation and applied retroactively.1 The facts of the case are as follows. The plaintiff funded his Roth IRA through a conversion rollover contribution of $69,059 from his existing traditional IRA. The contribution amount was included in the plaintiff's gross income, but was not subject to the Code's 10- percent tax under section 72(t) as provided by the Taxpayer Relief Act of 1997, which created the Roth IRA. On April 27, 1998, the plaintiff withdrew $53,000 from his Roth IRA for a non- qualified purpose (to make a mortgage payment). The plaintiff and his spouse reported the $53,000 distribution on their joint tax return filed on February 3, 1999, and submitted a payment of $5,300 to the IRS pursuant to section 72(t) in connection with the distribution. The plaintiff filed for a refund for the $5,300 amount, which was subsequently disallowed. The plaintiff then filed a complaint claiming that the retroactive imposition of the section 72(t) tax on the distribution violated his constitutional rights. The Taxpayer Relief Act of 1997 inadvertently permitted a taxpayer, following a conversion to a Roth IRA, to take an immediate, nonqualified distribution from a Roth IRA and avoid the section 72(t) tax — because that tax only applied to amounts includible in gross income. In light of this unintended consequence, Congress indicated, beginning in August 1997, that it would consider a cure to this problem. In December 1997, the IRS published interim guidance indicating that the House of Representatives had passed a technical correction addressing the issue, and that the legislation, if enacted, would be retroactive to January 1, 1998. 1 See Institute Memorandum to Pension Members No. 38-98, Pension Operations Advisory Committee No. 24-98, Transfer Agent Advisory Committee No. 34-98, Ad Hoc Committee on Roth IRA, and Ad Hoc Committee on Education IRA, dated June 29, 1998; Institute Memorandum to Pension Members No. 47-98, Pension Operations Advisory Committee No. 31-98, Transfer Agent Advisory Committee No. 43-98, Ad Hoc Committee on Roth IRA, and Ad Hoc Committee on Education IRA, dated July 24, 1998. 2The change became law in July 1998 with the enactment of the IRS Restructuring and Reform Act of 1998, under which

taxpayers could not avoid the section 72(t) tax on nonqualified distributions from Roth IRAs. Due Process Clause. The court rejected the plaintiff's argument that the retroactive imposition of the section 72(t) tax violated the Due Process Clause on the grounds that it was rational to apply a cure retroactively to prevent "taxpayers from taking advantage of the legislative process," and because it prevented a potentially significant and unanticipated revenue loss. Furthermore, the court viewed the one-year period of retroactivity as "modest" and "customary congressional practice." Takings Clause. To be treated as a "taking without just compensation," the court noted that the plaintiff had to demonstrate Congress "impose[d] severe retroactive liability on a limited class of parties that could not have anticipated the liability, and the extent of that liability is substantially disproportionate to the parties' experience." The court rejected plaintiff's argument on numerous grounds. First, the court held that no "property" under the Takings Clause had been implicated. Second, even assuming that "property" was involved, the retroactive imposition of the tax was rationally related to the legitimate purpose of curing Congress' mistake and recouping tax benefits improperly conferred. Third, the retroactive liability only reached back with respect to a "modest" period. Fourth, the plaintiff could have anticipated the liability since it was well known that Congress intended to cure the mistake. Finally, the liability was consistent with what the plaintiff would have experienced with nonqualified distributions from his traditional IRA — the imposition of the 10-percent tax. Excessive Fines Clause. Noting that a civil penalty had to be a "punishment" to violate the Eighth Amendment's Excessive Fines Clause, the court looked to Supreme Court case law holding that a civil forfeiture imposed after a conviction is a "punishment" under the clause only if the "innocence" of the individual must be considered under the imposition. Observing that the retroactive application of the tax was unrelated to the culpability of the taxpayer and that it was not imposed after a criminal proceeding, the court held that the imposition of the tax was not a "punishment," and therefore, it did not violate the Excessive Fines Clause. Thomas T. Kim Assistant Counsel Attachment Attachment (in .pdf format)
