Forfeiture of an IRA

February 23, 2024

Take-Away: An IRA can be lost in a criminal forfeiture, which can be just the beginning of the IRA owner's problems.

Background: As a general rule, IRAs are not subject to the IRA owner's bankruptcy creditors and the IRA assets are also generally exempt from creditor claims under state law. A recent Tax Court decision provides a dramatic exception to the generalization that IRA balances are not subject to attachment and execution, particularly when the government is the 'creditor.'

Lonnie Wayne Hubbard v. Commissioner, U.S. Tax Court, February 6, 2024

Facts: Lonnie was a pharmacist in Kentucky who in late 2015 was indicted for various crimes related to the distribution of controlled substances. The criminal indictments included allegations of Lonnie's assets, including a T. Rowe Price Associates, Inc IRA. Lonnie was convicted in 2017. Lonnie's property that was listed in the indictment was condemned and forfeited to the government (USA.) Not to be overlooked, Lonnie was sentenced to prison for 360 months. T. Rowe Price then issued Lonnie a Form 1099-R reporting an early IRA distribution to Lonnie of $427,518. However, Lonnie did not file a federal income tax return for the year of the distribution, which was also the year of his conviction and start of his incarceration. A Notice of Tax Assessment was made in 2020. Lonnie responded to the Notice claiming that the tax deficiency was invalid since his IRA funds were transferred directly to the USA and that he never constructively receive the IRA funds. Lonnie also claimed that he had reasonable cause for his failure to timely file a return and failure to timely pay the tax since he was incarcerated and his assets, including his IRA, were criminally forfeited. Finally, as a sign that 2017 was not one of Lonnie's better years, Lonnie claimed that he did not receive the Form 1099-R from T. Rowe Price because his wife divorced him, she did not communicate with him, and she did not forward his mail. [That sounds a bit more plausible than 'my dog ate my homework' excuse.]

Tax Court Decision: To put it mildly, the Tax Court showed Lonnie no sympathy.

- Discharge of Obligation Equivalent to Receipt: When an individual's funds are criminally forfeited to the USA to satisfy a forfeiture judgment, the individual is not relieved of the income tax consequences that would have attached to the funds without the forfeiture. By forfeiting the IRA funds, the IRA owner has realized the benefits of them and he must recognize the funds as gross income to the same extent as if he had physically received them. In the Supreme Court decision *Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929)* the Court held that a discharge by a third-person of an obligation of the taxpayer is equivalent to receipt by the person taxed.

- Taxed, Though Involuntarily Distributed: IRA funds constitute gross income as an involuntary distribution when forfeited to a third-party. *Rodrigues v. Commissioner, T.C. Memo 2015-178.* [IRC 61(a)(10); IRC 408)(d)(1).] Several reported case were cited in the Tax Court decision that supports this conclusion.

- Constructive Receipt of Taxable Income: The Court held that Lonnie's T. Rowe Price IRA funds were forfeited to the USA as an involuntary distribution. While they were not under his control, Lonnie constructively received the funds by having received the economic benefit of the funds through satisfaction of his forfeiture liability to the USA. The fact that Lonne did not willfully or purposefully cause the distribution is irrelevant. Consequently, Lonnie constructively received the IRA distribution and he had to include in his gross income the taxable distribution of $427,518 from his T. Rowe Price IRA.

- 'Piling It On:' In addition to Lonnie having to include in his taxable income for the year of the issuance of his Form 1099-R which was claimed by the IRS on forfeiture, Lonnie was liable for an addition to tax of $37,204 for his failure to timely file [IRC 6651(a)(1)], an addition to tax of $28,937 for his failure to timely pay the tax [IRC 6651(a)(2)], and an addition to tax of $3,959 for his failure to make estimated payments. [IRC 6654(a).]

Conclusion: It may come as a surprise to many that an IRA can be seized by the government if it is included in the indictment as part of a crime, or the product of the crime. It was bad enough for Lonnie to lose $427,000 in an IRA account that he never actually received. But then, Lonnie incurred the federal income tax liability on the early distribution of that phantom distribution amount, and then the IRS piled-it-on with another $72,000+ in additional taxes and penalties for failing to file while he was in prison. While I don't shed any tears for Lonnie and his actions, this case is one that I will remember for a long time as an unique example that 'crime does pay- but to the government.'