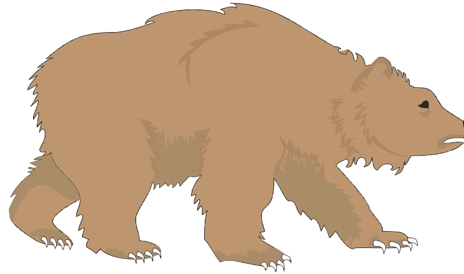
IRAS WITH HAIR

The IRA Emergency Rescue Guide



By: Natalie B. Choate, Esq.
Nutter McClennen & Fish LLP/ Boston, MA
www.ataxplan.com
All rights reserved

SUMMARY CONTENTS

INTRODUCTION: CHUTES AND LADDERS 5

I. HAIRY SCENARIOS: YOUR CLIENT'S FACTS 5

II. THE CHUTES: THE TAX CODE'S PUNISHMENTS 17

III. THE LADDERS: WAYS TO FIX THINGS 29

IV. THINGS YOU NEED TO KNOW TO APPLY THE PRECEDING PARTS 51

Some material in this Seminar Outline is excerpted from the 7th ed. (2011) of the book *Life and Death Planning for Retirement Benefits* (Ataxplan Publications) by Natalie B. Choate. The book may be ordered by calling 800-247-6553, or on line at www.ataxplan.com, for $89.95 plus shipping. All rights reserved. The text, especially the "Where to read more" paragraph at the end of each section, contains cross references to portions of the book (indicated by the "¶" symbol) that provide further explanation of topics that are touched on but not discussed in this outline.

Detailed Table of Contents

Abbreviations and Symbols Used in this Seminar Outline 4
Warning: Topics Not Covered in this Outline 4

INTRODUCTION: CHUTES AND LADDERS 5

I. HAIRY SCENARIOS: YOUR CLIENT'S FACTS 5
❦1.1 Attempted Roth Conversion of the RMD 5
❦1.2 Other Ineligible Purported Roth Conversions 6
❦1.3 Problems in Recharacterizing a Roth IRA Conversion 6
A. The Roth converter dies after the conversion 7
B. Transferring the wrong amount 7
C. Transferring to the wrong plan 8
D. Using 60-day rollover instead of trustee-to-trustee transfer 8
❦1.4 Transferring Funds from a Roth IRA to a NonIRA Plan 8
❦1.5 Missing the 60-day Rollover Deadline 9
A. First-time homebuyer 10
B. Disaster-based extensions 10
C. Qualified reservist distribution 10
D. One-year deadline for certain financial institution errors 10
E. Frozen deposits 11
❦1.6 Rolling over the Wrong Asset 11
❦1.7 IRA-to-IRA Rollovers: One-Per-12-Months Rule 12
❦1.8 Nonspouse Beneficiary Rollover Mistakes with Inherited Benefits 13
A. Attempted 60-day rollover 14
B. Direct transfer to inherited IRA by ineligible beneficiary 14
C. "Roth conversion" of inherited IRA 15
D. Direct transfer into beneficiary's own IRA 15
❦1.9 Missing the required minimum distribution (RMD) 15
❦1.10 Investment Mistakes and Problems 16
A. Direct ownership of "IRA" assets (no custodian) 16
B. Unrelated Business Taxable Income 17

II. THE CHUTES: THE TAX CODE'S PUNISHMENTS 17
❦2.1 Failed Conversions (Failed Roth Conversions) 17
❦2.2 Penalty for Excess IRA Contributions 18
❦2.3 Deemed Distributions 19
A. Pledging an IRA as security for a loan 20
B. Other assignments, pledges, or transfers 20
C. IRA acquires collectible 21
❦2.4 Plan Loan Problems 21
A. Deemed distribution caused by "flunking" § 72(p) 21

B. Plan loan offset distributions 22
C. Who gets the "offset" when participant dies? 23
❦2.5 Other "Unintended Distributions" 23
❦2.6 Punishments for Failure to Distribute the RMD 24
A. What is the "return" you have to file? 25
B. How to avoid the six-year statute 26
❦2.7 10 Percent Penalty for Early Distribution [topic not covered in this Outline] . . . 26
❦2.8 Prohibited Transaction with an IRA 26
A. The penalty for an IRA prohibited transaction. 27
B. Transactions that are prohibited 27
C. Who are disqualified persons? 28
D. Exemptions 28
E. Enforcement of the prohibited transaction rules 28
F. Recommendations for advisors 29

III. THE LADDERS: WAYS TO FIX THINGS 29
❦3.1 IRA Contributions Returned Before Tax Return Due Date 29
A. Deadline for a corrective IRA distribution 30
B. Income attributable to returned IRA contribution 30
C. No deduction taken 30
D. Income tax treatment 30
E. 10 percent penalty treatment 31
F. Effect on six percent penalty 32
G. Corrective distribution example 32
❦3.2 Quasi-Corrective Distributions 32
❦3.3 Excess IRA Contributions, cont.: Late return or "Absorption" 33
A. Income tax effect 33
B. Effect on 6% penalty 33
C. Absorption of excess IRA contribution 34
D. Late-returned excess contribution example 34
❦3.4 Rollovers: The Miracle Cleanup Machine 35
❦3.5 Hardship Waiver of the 60-day Rollover Deadline 37
A. Procedure to request a waiver 37
B. Earnings and RMDs during the out-of-plan gap period 37
C. Typical grounds for granting waiver: Advisor error, illness, etc. 38
D. Typical grounds for denying waiver: Participant spent funds, etc. 39
E. Evolving and inconsistent IRS standards 39
❦3.6 Recharacterization of an IRA Contribution 40
5.6.01 Which IRA contributions may be recharacterized 41
5.6.03 How to recharacterize certain IRA/Roth IRA contributions 42
5.6.04 Partial recharacterizations 43
5.6.07 Same-year and immediate reconversions banned 43
❦3.7 Missing the Recharacterization Deadline: 9100 Relief 44

❦3.8 Getting out from under the Penalty for Missed RMD 46
❦3.9 Undistributing: The Law of the 1099-R 50
❦3.10 Sue somebody! 51

IV. THINGS YOU NEED TO KNOW TO APPLY THE PRECEDING PARTS 51
❦4.1 Recharacterization Deadline: Due Date Including Extensions 51
❦4.2 How to Compute Earnings on Returned or Recharacterized Contributions 53
❦4.3 "Regular Contribution" Versus "Rollover Contribution" 54
❦4.4 "60-day Rollover" Versus "Trustee-to-trustee Transfer" 55

Appendix A: Recommended Publications 56

Abbreviations and Symbols Used in this Seminar Outline

¶ Refers to a section of the author's book *Life and Death Planning for Retirement Benefits* (7th ed. 2011; www.ataxplan.com) that provides a definition and/or more information.
§ Refers to a section of the Code unless otherwise indicated.
❦ Refers to a section of this Seminar Outline.

Code Internal Revenue Code of 1986, as amended through July 31, 2014.
DOL Department of Labor.
EGTRRA The Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. 107-16).
ERISA Employee Retirement Income Security Act of 1974.
IRA Individual retirement account or individual retirement trust under § 408 or § 408A.
IRS Internal Revenue Service.
PLR IRS private letter ruling.
QRP Qualified Retirement Plan.
RBD Required Beginning Date.
RMD Required minimum distribution. See ❦1.9.
Reg. Treasury Regulation.
Roth IRA A Roth IRA established in accordance with § 408A of the Code.
Traditional IRA An IRA that is not a Roth IRA.

Warning: Topics Not Covered in this Outline

This Outline deals with "honest" mistakes and garden-variety slip-ups involving IRAs. It does not cover the problems that arise when there are more serious mistakes and/or intentional abuse of the IRA vehicle, such as listed transactions or fraudulent or criminal activities. This Outline also does not cover the 10 percent penalty on early distributions (§ 72(t)).

IRAS with Hair: The IRA Emergency Rescue Guide

By:

Natalie B. Choate, Esq.

INTRODUCTION: CHUTES AND LADDERS

The world of IRA mistakes is like the children's game "Chutes and Ladders." Your client "A" tried to roll over his required minimum distribution? DOWN he goes, descending the "ineligible rollover" chute. At the bottom he lands in a bad place…excess IRA contribution! Another client, "B," failed to take a required minimum distribution from the IRA she inherited…she tumbles down the "missed RMD" chute and lands on the "50 percent penalty box." Still a third client, "C," took a distribution at retirement, intending to roll it over to an IRA, but missed the 60-day rollover deadline. He zooms down the chute marked "unintended distribution" and lands in the box marked "pay income tax earlier than you expected!" Other "chutes" are called "titling mistake," "failed Roth conversion," "inadvertent distribution," "UBTI," and "disqualification."

But the Code also offers "ladders," ways our clients can climb out of their bad results and get back to the sunny promised land of safe retirement plans and no penalties. "A" can use the corrective distribution ladder to fix his excessive rollover. "B" can use the "request penalty waiver" ladder to avoid the penalty on her missed RMD. "C" can ascend the "request hardship waiver" ladder to salvage his rollover. Other ladders include "recharacterization," "deemed spousal election," and "absorption."

This "game" is anything but fun for the client who finds himself faced with an unexpected distribution and/or penalty. The best way to help your clients is to make sure they avoid the "chutes" in the first place. But for the client who does not heed your advice, or for that new client who did not have the benefit of your advice, your knowledge of the "chutes and ladders" will be a life saver.

I. HAIRY SCENARIOS: YOUR CLIENT'S FACTS

❦1.1 Attempted Roth Conversion of the RMD

A required minimum distribution (RMD) cannot be "converted" to a Roth IRA. That's because a Roth conversion is considered a rollover, and an RMD is not an eligible rollover distribution. § 408(d)(3)(E). (Basically a Roth conversion is a taxable rollover.) What's more, the first distribution of the year is always the RMD.

Bogey Example: In 2014, Bogey turns age 73. He owns an IRA that was worth $1 million on 12/31/2013 and is still worth $1 million. He transfers the $1 million to a Roth IRA, because he wants to do a Roth conversion. The trouble is, he failed to take the RMD ($40,485.83) for 2014 prior to doing the Roth conversion. What's the problem and what's the remedy?

The rollover/Roth conversion is valid as to the $959,514.17 in excess of the RMD. However, the conversion is a **failed conversion** as to the $40,485.83 RMD that was not eligible to be converted. Reg. § 1.408A-4, A-6. A failed conversion is generally treated for tax purposes as if the amount transferred to the Roth IRA had been (1) distributed from the original plan or IRA and then (2) contributed to the Roth IRA as a "regular contribution." See "Failed Conversions," ❦2.1.

This is good news and bad news for Bogey. It means he is deemed to have taken his 2014 RMD (because the $40,485.83 is treated as if it had been distributed to him), so he is not liable for the penalty for failure to take an RMD (see ❦2.6). However, since he is deemed to have contributed the $40,485.83 to the Roth IRA as a "regular contribution" (as opposed to a "rollover contribution"), he has an excess IRA contribution problem. See ❦2.2.

<u>Where to read more</u>: For the requirements of a valid rollover and a valid Roth conversion respectively, see ¶ 2.6.02 and ¶ 5.4.01–¶ 5.4.02 of *Life and Death Planning for Retirement Benefits*. For the rules that the RMD cannot be converted, and that the first distribution of the year is the RMD, see ¶ 2.6.03.

❦1.2 Other Ineligible Purported Roth Conversions

It shouldn't be common but it is: An individual who is not eligible to do a Roth conversion does one anyway, or an individual who could have done a valid Roth conversion does it incorrectly. Here is how it can happen to a participant; for flubbed Roth conversions by *beneficiaries*, see ❦1.8.

✓ Prior to 2010, a participant rolled or transferred money from his traditional retirement plan or IRA into a Roth IRA during a year when such participant had modified adjusted gross income (MAGI) in excess of $100,000 or filed his income tax return using "married filing separately" status. Prior to 2010, an individual with MAGI in excess of $100,000 or who filed as "married filing separately" was not eligible to do a Roth conversion.

✓ An individual purports to "re-convert" to a Roth IRA an amount that had been previously converted to a Roth, then recharacterized, and the purported reconversion takes place before the necessary waiting period has ended (i.e., it takes place in the same tax year as the first conversion, or within 30 days after the recharacterization); see ❦3.6 (subsection 5.6.07).

In all of these cases, the Roth conversion "fails." The result is a "failed conversion." See ❦2.1 for how the transaction is treated.

❦1.3 Problems in Recharacterizing a Roth IRA Conversion

❦3.6 explains what a "recharacterization" is and how it can be useful in reversing an undesired Roth conversion or even a "failed" Roth conversion. The problem is, just as it is possible to "mess up" a Roth conversion, it is also possible to "mess up" the attempted recharacterization of a Roth conversion. Here are problems that can arise with the attempted recharacterization of a Roth

conversion; if the problem is that the would-be recharacterizer missed the applicable deadline for recharacterizing, see ❦3.7.

A. The Roth converter dies after the conversion

This discussion assumes that a participant did a Roth IRA conversion, then died prior to the deadline for recharacterizing the conversion. In most cases, that deadline is October 15 of the year after the year of the conversion; see ❦4.1.

According to the regulations, the recharacterization election "may be made on behalf of a deceased IRA owner by his or her executor, administrator, or other person responsible for filing the final Federal income tax return of the decedent under section 6012(b)(1)." Reg. § 1.408A-5, A-6(c).

Although this sounds reasonable, there is a significant "mechanical" problem with the regulation's approach. A recharacterization is accomplished by transferring the conversion contribution, plus earnings thereon, out of the Roth IRA and into a traditional IRA by means of an IRA-to-IRA transfer. See ❦3.6. Unless the deceased participant's estate is, itself, the beneficiary of the Roth IRA, it is not clear how the executor will persuade the IRA sponsor to transfer the money to a different IRA when the executor does not have title to the account; the *beneficiary* owns the account from the moment the participant dies. For more discussion of this problem and ways to deal with it at the planning and administration stages, see ¶ 4.1.02 of *Life and Death Planning for Retirement Benefits* or see the *"Special Report: Estate Administrator's Guide: Advising Executors and Beneficiaries*," downloadable at www.ataxplan.com.

B. Transferring the wrong amount

If the would-be recharacterizer transfers the wrong amount from his Roth IRA to a traditional IRA, the consequences vary depending on whether he transferred too much or too little.

If he transferred LESS than would be required to effect the desired recharacterization, he is simply deemed to have recharacterized less of his Roth conversion than he thought he had recharacterized. If the deadline for recharacterization has not yet passed at the time this mistake is discovered, it should be correctable by transferring the rest of the required amount over to the traditional IRA. If not so cured, the result is that the Roth conversion remains effective as to the shortfall—the amount not successfully recharacterized—and the individual will either have a valid taxable Roth conversion to that extent (if he was attempting to recharacterize a valid Roth conversion) or will have an uncured "failed" Roth conversion to that extent (if he was trying to fix a failed conversion; see ❦2.1).

If he transferred MORE than he should have from the Roth IRA to the traditional IRA, he has a valid recharacterization as to the amount of the contribution (and related earnings) included in the transfer, and (as to the excess portion of the transfer) he has a deemed distribution from the Roth account followed by a regular contribution to the traditional IRA; see ❦1.4.

C. Transferring to the wrong plan

If the amount that is supposedly being recharacterized is not transferred to a traditional IRA beneficially owned by the same person who owned the Roth IRA, but is instead transferred to the wrong type of plan (such as a 401(k) plan) or to an account in the wrong name, you do not have a valid recharacterization. What you have is a distribution from the Roth account followed by a "regular contribution" to the recipient account; see ❦4.3.

D. Using 60-day rollover instead of trustee-to-trustee transfer

One requirement of a valid recharacterization is that the recharacterized contribution (plus or minus earnings thereon) must be transferred from the Roth IRA to the traditional IRA by means of a trustee-to-trustee transfer. If that does not happen, and the money is instead distributed out of the Roth IRA to the individual, there is no recharacterization. The original Roth conversion maintains its status as a valid or failed Roth conversion (as the case may be), and the individual has received a distribution from the Roth IRA.

There are no IRS pronouncements on this situation, but it appears that if the mistake is caught within 60 days, and the distribution from the Roth IRA is an eligible rollover distribution (see ❦3.4), the distribution could be rolled back into the Roth IRA tax-free to restore the status quo; and possibly the individual could *then* do his recharacterization if he is still within the deadline for completing a recharacterization.

Except for that possible escape hatch, this mistake is a dead end; there is no "ladder" out that can save or restore the recharacterization process.

❦1.4 Transferring Funds from a Roth IRA to a NonIRA Plan

Once money is validly in a Roth IRA, there is generally no ability, and no reason, to transfer that money back to a traditional IRA or plan. The only exception is a timely "recharacterization" of a contribution (see ❦3.6), which is a way to undo a Roth contribution or conversion within a limited period of time after it is made.

Percy Example: Percy has a $400,000 Roth IRA and has had it for many years. Due to a mistake by himself or by his financial institution or advisor, the Roth IRA is closed in 2014 and all funds in the account are transferred into Percy's traditional IRA. Here is what the IRS has to say about this sequence, from Reg. § 1.408A-6, A-17:

"Q-17. What is the effect of distributing an amount from a Roth IRA and contributing it to another type of retirement plan other than a Roth IRA?

"A-17. Any amount distributed from a Roth IRA and contributed to another type of retirement plan (other than a Roth IRA) is treated as a distribution from the Roth IRA that is neither a rollover contribution for purposes of section 408(d)(3) nor a qualified rollover contribution within the meaning of section 408A(e) to the other type of retirement plan. This treatment also applies to any

amount transferred from a Roth IRA to any other type of retirement plan unless the transfer is a recharacterization described in Sec. 1.408A-5."

Thus, Percy is treated as having received a distribution of his entire Roth account and he no longer has a Roth IRA. The distribution is not treated as a tax-free rollover contribution to the traditional IRA (§ 408(d)(3)). If Percy is disabled or over age 59½ and has had a Roth IRA for more than five years, the distribution should be nontaxable as a "qualified distribution" from a Roth IRA. Otherwise the distribution will be includible in Percy's gross income (as a nonqualified distribution from a Roth IRA) to the extent it exceeds his basis.

Because the contribution to the traditional IRA is not a valid rollover contribution, it is treated as a "regular" contribution. See ❦4.3. To the extent the contribution exceeds the amount that Percy would otherwise be permitted to contribute to a traditional IRA for 2014, it is an Excess IRA Contribution (see ❦2.2). Here are two approaches Percy should consider to fix this problem:

✓ It would appear that Percy's mistake can be fixed by means of a recharacterization—moving the $400,000 mistaken IRA contribution (plus any earnings thereon; see ❦4.2) by means of a trustee-to-trustee transfer back into the Roth IRA, *if* Percy could have validly rolled that $400,000 Roth IRA distribution into a different Roth IRA. See ❦3.6 for the requirements for a valid recharacterization. Recharacterization is not normally available for "rollovers" (other than rollovers that are Roth conversions), but Percy's IRA contribution did not qualify as a "rollover," so it does not fall within that prohibition. See Reg. § 1.408A-5, A-4.

✓ Another route would be, after removing the contribution and its earnings from the traditional IRA, to apply for a "late rollover" (to a Roth IRA) of the original distribution. See ❦3.5.

Where to read more: For definitions and details regarding "qualified" and "nonqualified" Roth IRA distributions, see § 408A(d) and ¶ 5.2.03–¶ 5.2.07 of *Life and Death Planning for Retirement Benefits*.

❦1.5 Missing the 60-day Rollover Deadline

The client received a retirement plan distribution that was intended to be "rolled over" into another retirement plan or an IRA, but for some reason the money didn't get into the recipient plan within 60 days after it came out of the distributing plan. Normally, 60 days is the deadline for completing a "rollover" of funds from one retirement plan to another (or back into the same plan) in order for the distribution not to be treated as a distribution from the original plan. § 402(c)(3)(A); § 408(d)(3)(A). The result of failing to meet the rollover deadline is an **Unintended Distribution**; see ❦2.5.

Before concluding that your client has an Unintended Distribution, however, first make sure that there really was a 60-day deadline and that the client really did miss it. Here are some "close call" scenarios, that may mean your client didn't miss the deadline after all, so he does not (or does not yet) have an Unintended Distribution:

✓ First, determine whether there really was a "distribution" that had to be rolled over. If the "distribution" was in fact a trustee-to-trustee transfer (rather than a "distribution"), see ❦4.4 regarding whether the 60-day deadline applies to trustee-to-trustee transfers (some private letter rulings say it does not).

✓ Make sure the deadline really is 60 days. Paragraphs (A) through (E) below list the situations that have a longer-than-60-day period in which to complete the "rollover"; if the client does not fit into any of these exceptions, see ❦2.5 and ❦3.5.

A. First-time homebuyer

There is a 120-day rather than a 60-day deadline for the rollover of a "first-time homebuyer" distribution if the distribution is not used to purchase the residence "solely by reason of a delay or cancellation of the purchase or construction of the residence." The recontribution of the thwarted homebuyer distribution is also not treated as a rollover for purposes of the one-per-12-months rule (❦1.7). § 72(t)(8)(E); PLR 2004-23033. See ¶ 9.4.09 of *Life and Death Planning for Retirement Benefits* for discussion of "first-time homebuyer" distributions.

B. Disaster-based extensions

The IRS tends to grant blanket extensions for this and other tax deadlines in the case of certain federally-recognized disasters. See the IRS pronouncement applicable to the disaster in question (*e.g.*, IRS News Release IR-2004-115 extending deadlines for taxpayers affect by Hurricane Frances).

C. Qualified reservist distribution

A qualified reservist distribution (QRD) may be "rolled into" (i.e., contributed to) an IRA or Roth IRA at any time during the *two-year period* that begins on the day after the end of the reservist's active duty period. § 72(t)(2)(G). However, unlike "normal" rollovers, the rollover contribution of a QRD (if it occurs more than 60 days after the original distribution) does not erase the taxable income that resulted from the original distribution. The only advantage of this type of rollover is that (if the reservist has enough cash to replace the money he withdrew during his active duty service) this provision enables him to replace the funds in an IRA without regard to the normal limits on IRA contributions. Since there is no tax deduction allowed for the contribution, it is advisable to make the contribution to a Roth IRA, so future earnings on the contribution will be tax-free. The "rollover" is reported on Form 8606 as a nondeductible contribution to an IRA. For more discussion of QRDs, see ¶ 9.4.12 of *Life and Death Planning for Retirement Benefits*.

D. One-year deadline for certain financial institution errors

The 60-day deadline is *automatically* waived in the following circumstances: The participant received a distribution after 2001, and (within the 60-day limit) transmitted the funds to a financial

institution and did everything else required (under the financial institution's procedures) to deposit the funds in an eligible retirement plan, but "solely due to an error on the part of the financial institution" the funds were not deposited into the eligible retirement plan within 60 days of the original distribution. Provided the funds are deposited in the eligible plan within one year of the original distribution, there is an automatic waiver of the 60-day rollover deadline, and no need to seek IRS approval. Rev. Proc. 2003-16, 2003-1 C.B. 359, § 3.03.

E. Frozen deposits

What if the participant receives a distribution and deposits the money in a bank, and then the bank becomes insolvent so the participant can't get his money out in time to complete the rollover? The 60-day period does not include the time during which the money is "frozen," or end until at least 10 days after the money becomes "unfrozen." § 402(c)(7)(B), § 408(d)(3)(F).

❦1.6 Rolling over the Wrong Asset

If cash is distributed to the individual, and he wants to avoid income tax on the distribution by rolling it over to another plan or IRA, the individual must roll cash. He can't buy something with the cash then deposit the newly purchased investment in the IRA. § 408(a)(1).

For an example of someone making this mistake, see PLR 2011-43027, in which Taxpayer A wanted to "take advantage of a loan investment opportunity through a self-directed IRA." Specifically ("at the behest of his financial advisor") he wanted his IRA to buy "investment notes from Fund C." He moved money out of his IRA to accomplish this and entrusted the transaction to his financial advisor. The advisor caused the notes to be purchased in Taxpayer A's taxable account, then contributed the notes to a rollover "self-directed" IRA. But because Taxpayer A had received a *cash* distribution from the first IRA he was required to roll *cash* to the recipient IRA in order to have a valid rollover. Because this was an advisor error, Taxpayer A sought and received permission for a "late rollover" of the cash (see ❦3.5). To correct the original invalid rollover which was presumably treated as an excess IRA contribution (see ❦2.2), Taxpayer A presumably had to take a corrective distribution of the notes (see ❦3.1), though this aspect is not discussed in the ruling.

Similarly, if the retirement plan or IRA distributes property to the participant rather than cash, and the participant wants to avoid tax by rolling the distribution over, he generally has to roll over to the recipient plan or IRA the *same property that was distributed to him*. He cannot use the rollover to in effect swap assets between his retirement plan and his taxable account. The only exception to this rule is, if the property was distributed from a *qualified plan*, and the participant then sells the property while it is outside the plan, he can roll over the sale proceeds and the sale itself will not be taxable. This exception for sale of the distributed property does not apply to property distributed from an *IRA*. § 402(c)(1)(C), (c)(6); § 408(d)(3)(A); Rev. Rul. 87-77, 1987-2 C.B. 115.

If the individual violates this rule, his "rollover" does not meet the requirements of a tax-free rollover, and therefore he has an Unintended Distribution (see ❦2.5) followed by a regular IRA contribution (see ❦4.3) which is probably an Excess Contribution (see ❦2.2).

❦1.7 IRA-to-IRA Rollovers: One-Per-12-Months Rule

A participant or surviving spouse may not roll over an IRA distribution to the same or another IRA "if at any time during the 1-year period ending on the day of…[the receipt of the distribution] such individual received any other amount...from an individual retirement account...which was not includible in his gross income because" it was a tax-free rollover to an IRA. § 408(d)(3)(B). The application of this rule changes for distributions occurring after 2014 as a result of the *Bobrow* case (*Bobrow v. Comm'r*, TC Memo 2014-21 (1/28/14)).

Under the statute, it appears that the tax-free rollover of a distribution from *any* IRA into the same or any other IRA prevents the tax-free rollover of any *other* IRA distribution that is received less than 12 months after the first distribution—regardless of which IRA the second distribution came from. However, prior to the *Bobrow* case, the IRS applied the rule on an account-by-account basis: Once you had rolled over a distribution from one IRA (IRA #1) into another IRA (IRA #2), you could not, within 12 months after the date of the distribution that was rolled over, do an IRA-to-IRA rollover of any *other* distribution from *either of the two IRAs involved in the first rollover*. However, you could (within that 12-month period) roll over a distribution from an IRA that was *not* involved in the first rollover. See discussion and example at IRS Publication 590 (2013), p. 25.

In *Bobrow*, the Tax Court held that the IRS's interpretation was incorrect: The Code clearly prohibited a second IRA-to-IRA rollover within 12 months after any prior IRA distribution that was rolled over to an IRA, regardless of how many different accounts were involved. The IRS announced that it would accept the Court's interpretation, but (in view of its longstanding contrary position) would not apply the "new" rule to distributions made before 2015. IRS Announcement 2014-15, 2014-16 IRB 974 (3/20/14).

The once-per-year rule (in both its pre-2015 and post-2014 versions) is easy to AVOID: Just use direct IRA-to-IRA transfers (also called trustee-to-trustee transfers) instead of indirect ("60-day") rollovers. See ❦4.4. **The limit of one IRA-to-IRA rollover per 12 months has no application to a direct transfer of funds or property from one IRA custodian to another IRA custodian (IRA-to-IRA transfer).** A participant can do as many direct IRA-to-IRA transfers as he wants in any time frame.

Once the participant has taken money out of the IRA and placed it in his taxable account, it becomes too late to do an IRA-to-IRA transfer. In that case, the money cannot be rolled over tax-free into either the same or any other IRA if, within the 12-month period prior to receipt of such distribution, the participant had received *another* IRA distribution that was rolled over tax-free into an IRA. If the participant wants tax-free rollover treatment for the second distribution, then the following are the only escape hatches:

♦ If the second distribution occurred prior to 2015, and it came from an IRA that was not involved (either as distributing account or as receiving account) in the prior IRA-to-IRA rollover, the second distribution can be rolled over to another IRA. IRS Announcement 2014-15, 2014-16 IRB 974 (3/20/14).

♦ If the second distribution was a "first-time homebuyer distribution," the once-per-12-months rule does not apply. See ❦1.5(A).

- ♦ If the second distribution came from a failed financial institution; see IRS Publication 590 (2013), p. 25.

- ♦ The participant can roll the second distribution into a nonIRA plan. § 408(d)(3)(B) prevents the rollover *into an IRA* of a second IRA distribution made within 12 months; it does not prevent a rollover of such a second IRA distribution into *some other kind of eligible retirement plan*, nor does it prevent multiple tax-free rollovers *into* an IRA from some other type of plan. Thus you can avoid § 408(d)(3)(B) by rolling the second IRA distribution into a QRP and then rolling it out again to another IRA shortly thereafter. If the participant does not have a nonIRA plan he can roll the second distribution into, then:

- ♦ If the second distribution came from a traditional IRA, the participant should deposit it within 60 days into a Roth IRA (Roth conversion). Neither a Roth conversion, nor the "recharacterization" of an IRA or Roth IRA contribution, is treated as either a distribution or a rollover for purposes of the once-per-12-months rule. Reg. § 1.408A-4, A-1(a); § 1.408A-5, A-8. Thus, the individual (if he does not want a Roth conversion) can later recharacterize the unwanted Roth conversion and move the money back into a traditional IRA (see ❦3.6).

Unfortunately, if the client has already deposited the second distribution into an IRA, and none of the above exceptions applies, the situation may not be salvageable. The rollover is not valid, so the second distribution is taxable and the contribution of the second distribution to an IRA is a "regular" contribution, not a "rollover" contribution. The client has an Unintended Distribution (see ❦2.5) and (probably) an Excess IRA Contribution (see ❦2.2).

The only conceivable escape-hatch option is (if the second distribution was rolled to a traditional IRA) to "recharacterize" the second IRA contribution as a Roth conversion and move the money to a Roth IRA. It would still be taxable in that case, but at least the participant would be getting something of value (a Roth IRA) for his income tax payment. There is no published example of using a recharacterization in this situation and no specific IRS pronouncement on its validity.

Where to read more: See ❦4.4 for the difference between rollovers and trustee-to-trustee transfers. For explanation of Roth conversions, see ¶ 5.4 of *Life and Death Planning for Retirement Benefits*. For recharacterizations, see ❦3.6 .

❦1.8 Nonspouse Beneficiary Rollover Mistakes with Inherited Benefits

It is all too easy for nonspouse beneficiaries to make mistakes when transferring benefits from an inherited plan. A nonspouse beneficiary can do only two kinds of post-death transfers with respect to the inherited benefits:

- ✓ If the beneficiary is a "Designated Beneficiary" with respect to an inherited nonIRA plan, the beneficiary can direct the plan to transfer the inherited benefits, via direct rollover (trustee-to-

trustee transfer) into an "inherited" IRA or Roth IRA in the name of the same deceased participant and payable to the same beneficiary.

✓ With respect to an inherited IRA, any beneficiary can cause the IRA assets to be transferred directly into another "inherited IRA" in the name of the same decedent and beneficially owned by the same beneficiary.

That's it. Here are other types of transfers (the NON-permitted ones) that the beneficiary may attempt to do. These other types of transfers are NOT permitted rollovers or transfers. The result of doing any of the following is that the distribution from the first plan is not sheltered from taxation by any Code provision and accordingly it is an Unintended Distribution (see ❦2.5). The contribution into the recipient plan is considered a regular (not rollover) contribution to the recipient IRA (see ❦4.3 for the difference), and will typically be an Excess Contribution (see ❦2.2). So don't let your nonspouse beneficiary client fall down the following "chutes":

A. Attempted 60-day rollover

The nonspouse beneficiary takes a distribution out of an inherited plan or IRA, and wishes to "roll" the distribution back into an inherited IRA within 60 days. This does not work. If, after the participant's death, the retirement plan or IRA makes a distribution to a beneficiary who is not the participant's surviving spouse, that distribution cannot be rolled over. It cannot be rolled back into the plan or IRA it came out of, or into any other plan or IRA. Not within 60 days, not within 60 seconds. Not to the beneficiary's own IRA and not to an inherited IRA. This rule applies to every beneficiary who is not the participant's surviving spouse, whether or not such beneficiary is a "Designated Beneficiary."

However, despite the apparent clarity and finality of this rule under the law, there may nevertheless be a way around it, an approach I call "undistributing" the distribution; see ❦3.9.

Note re: Obama Proposal

President Obama has issued various proposed budget and tax law changes. One change he has proposed would be to permit nonspouse beneficiaries to do "60-day rollovers." This proposal may or may not ever make it into legislation that is ultimately enacted, but is included here just to illustrate one area of potential future change in the law.

B. Direct transfer to inherited IRA by ineligible beneficiary

The beneficiary arranges a trustee-to-trustee transfer from an inherited nonIRA plan into an "inherited" IRA in the name of the same decedent and beneficiary, BUT the beneficiary does not meet the definition of a "Designated Beneficiary." Since only *Designated Beneficiaries* are permitted to transfer funds from an inherited nonIRA plan to an inherited IRA, this transaction is not a valid rollover. It would be treated as a taxable distribution from the nonIRA plan followed by an excess contribution to the inherited IRA.

For the definition of "Designated Beneficiary," see § 401(a)(9)(E), Reg. § 1.401(a)(9)-4, A-1, and ¶ 1.7.03 of *Life and Death Planning for Retirement Benefits*.

C. "Roth conversion" of inherited IRA

A nonspouse beneficiary cannot convert an inherited IRA into an inherited Roth IRA. See § 408A(c)(6)(A) and explanation at ¶ 4.2.05(A) of *Life and Death Planning for Retirement Benefits*. A transfer of funds from an inherited IRA into an inherited Roth IRA would be treated as a distribution from the inherited traditional IRA, followed by an excess contribution to the inherited Roth IRA.

D. Direct transfer into beneficiary's own IRA

The beneficiary arranges a trustee-to-trustee transfer (so far so good), BUT the recipient IRA is the beneficiary's own IRA, not an "inherited" IRA in the name of the deceased participant. Once again, this is not a valid rollover; no one other than the surviving spouse can roll over inherited benefits into his/her own IRA. This is treated as a distribution from the first plan followed by a "regular" (not "rollover") contribution to the beneficiary's IRA. See ❦4.3 and see "Lola Example" at ❦3.1(G).

Where to read more: See ¶ 4.2 of *Life and Death Planning for Retirement Benefits* regarding what types of transfers and "rollovers" nonspouse beneficiaries can and cannot do. See ¶ 1.7.03 for definition of "Designated Beneficiary."

❦1.9 Missing the required minimum distribution (RMD)

The Tax Code requires retirement plan owners and beneficiaries of deceased owners to take certain distributions from the retirement plan or IRA. Failing to take the "required minimum distribution" (RMD) by the applicable deadline results in a penalty of 50 percent of the amount that was supposed to be withdrawn but wasn't; see ❦2.6. The rules regarding how much must be distributed and when are called the "minimum distribution rules."

Before you conclude that your client owes this penalty, you first need to be sure that your client actually did fail to take the full RMD. You need to go back over the years you are concerned about, year by year, and see what the RMD was and whether it was distributed or not. If after following all those trails you still conclude that your client did not take the right amount from the right account, see ❦3.8 regarding ways to get out of paying the penalty and ❦2.6 regarding how to compute the penalty.

Where to read more: For the minimum distribution rules, see § 401(a)(9) and regulations thereunder. These rules are explained in detail in Chapter 1 of *Life and Death Planning for Retirement Benefits*. The minimum distribution Road Maps in Chapter 1 are designed to alert you to any factors that might reduce the applicable RMD in any particular year (such as any applicable "grandfather rules," and the suspension of RMDs in the year 2009).

If you are doing this for a participant, to determine whether he took all applicable "lifetime" RMDs, start with ¶ 1.3.01 of *Life and Death Planning for Retirement Benefits*, the "Road Map for Computing Lifetime RMDs." Consult the "Road Map for Determining Post-Death RMDs" at ¶ 1.5.02 if advising a beneficiary. The Road Maps will guide you to the amount of the RMD for each year. If some distributions were made, but possibly not enough or possibly not from the right plan or account or possibly not to the right person, then see also the following sections of *Life and Death Planning for Retirement Benefits*:

✓ ¶ 1.2.02 to determine which distributions count or don't count towards the RMD.

✓ Regarding possible aggregation of plans or accounts for RMD purposes, see ¶ 1.3.04 and ¶ 1.3.05 (with respect to lifetime distributions) or ¶ 1.5.09 (for post-death distributions).

✓ In the case of post-death distributions, if there are multiple beneficiaries, see ¶ 1.7.06 regarding who must take the RMD.

❦1.10 Investment Mistakes and Problems

This section deals with mistakes that occur most often when the participant has attempted to invest his IRA in "nontraditional" investments such as privately-traded or non-traded partnership interests or hedge funds, or direct ownership of real estate or a business, but also covers unexpected problems that can arise with standard vanilla publicly traded investments. See also ❦2.3 regarding "deemed distributions" that can result from certain IRA investments.

A. Direct ownership of "IRA" assets (no custodian)

In order to have a valid IRA, the IRA's assets must be held by a BANK (or other institution that has gone through the IRS process for obtaining approval to hold IRA assets) as custodian or trustee. § 408(a)(2). An individual can NOT hold direct title to assets that are supposedly in his IRA. Thus, the title of a partnership unit held by an IRA should be "[Name of bank], as custodian [or trustee] of [name of participant] IRA."

This requirement can be easily overlooked when the IRA owner wants to invest in a hedge fund, LLC, or other private investment vehicle. The hedge fund accepts money that is supposed to be a rollover from an actual IRA or plan, deposits the money in its fund, and opens an account entitled "John Doe IRA." Because there is no bank holding title to the account, however, this investment is not "in" an IRA; it is owned by John Doe directly. The result is either that the money never gets into an IRA in the first place, or (if the money came out of a retirement plan and was supposedly "rolled over" into this new investment) there is no valid rollover, and thus there is an Unintended Distribution. See ❦2.5.

For rulings in which this mistake happened (and the IRS allowed it to be fixed via a waiver of the 60-day rollover deadline; see ❦3.5), see PLRs 2007-37047, 2007-37048, 2009-19066 (real estate limited partnership), 2009-21038 (limited partnership), 2009-31063 (investment pool); 2010-05058; 2011-04053–04056; 2011-04058–04060; and 2011-38051, 2011-38052, and 2011-39012.

B. Unrelated Business Taxable Income

Normally, IRAs are tax-exempt entities; however, like other tax-exempt entities, IRAs are subject to tax under § 511 on "unrelated business taxable income" (UBTI). § 408(e)(1). UBTI is generated if the IRA: owns a business in proprietorship or partnership form (even if the partnership is publicly traded—e.g., an oil and gas pipeline company); receives rental income of certain types; or receives "income from debt-financed property."

Where to read more: ¶ 8.2 of *Life and Death Planning for Retirement Benefits* provides an overview of the UBTI tax, for the estate planner, CPA, or financial planner who is advising an individual participant or beneficiary, emphasizing rules that personal advisers may not be aware of. An IRA owner and his adviser must seek UBTI-expert help (or become UBTI experts) if the IRA invests in nontraditional investments. For more on UBTI, see IRS Publication 598, *Tax on Unrelated Business Income of Exempt Organizations*.

II. THE CHUTES: THE TAX CODE'S PUNISHMENTS

The IRS has two basic weapons it can use to punish garden variety IRA mistakes. It can say that money you thought was *inside* the IRA or plan is really *outside* any plan; or it can assess one of the special retirement plan penalties (excess IRA contribution, early distribution, missed RMD). All the punishments listed here are variations or combinations of those weapons.

❦2.1 Failed Conversions (Failed Roth Conversions)

"The term **failed conversion** means a transaction in which an individual contributes to a Roth IRA an amount transferred or distributed *from a traditional IRA*... in a transaction that does not constitute a conversion under Sec. 1.408A-4 A-1." Reg. § 1.408A-8, A-1(b)(4) (emphasis added).

This definition has not been explicitly extended to include defective conversions *from nonIRA plans*. IRS Notice 2009-75, 2009-39 IRB 436, Part III, A-1(a), provides that the amount includible in gross income when there is a conversion to a Roth IRA from a nonIRA plan is determined "as if" the converted amount passed through a traditional IRA on its way to the Roth. Possibly the IRS intends that other rules applicable to IRA-to-Roth-IRA conversions, such as this definition of failed conversion, will automatically also apply to plan-to-Roth-IRA conversions, but there is no such IRS pronouncement to date.

The first element of a failed conversion is, there must be a transfer or purported rollover from a traditional IRA (or other retirement plan?) into the Roth IRA. The second element is that the amount transferred or rolled was not eligible to be converted to a Roth IRA. If only part of the amount transferred or rolled is ineligible, then the conversion is only partially "failed."

Here are some of the ways a failed conversion occurs:

✓ A person rolls over a required minimum distribution to a Roth IRA; see ❦1.1.

✓ A nonspouse beneficiary transfers or rolls funds from an inherited traditional IRA into an inherited Roth IRA or into his own Roth IRA. See ❦1.8(C).

✓ A nonspouse beneficiary transfers funds from an inherited traditional retirement plan into an inherited Roth IRA using a "60-day rollover" rather than a "direct rollover." See ❦1.8(A).

✓ An individual who has recharacterized a certain amount (i.e., "undone" a prior Roth conversion) attempts to "reconvert" the same amount to a Roth IRA before the time that he becomes eligible to do so (see ❦3.6, subsection 5.6.07, below).

A failed conversion is generally treated for tax purposes as if the amount transferred to the Roth IRA had been (1) distributed from the original plan or IRA and then (2) contributed to the Roth IRA as a "regular contribution" (❦4.3). See Regs. § 1.408A-4, A-3(b), A-6(c).

So a failed conversion generates two concerns: The deemed distribution and the deemed regular contribution. The "deemed distribution" portion can IN SOME CASES be corrected by "recharacterization" (see ❦3.6) or possibly "late rollover" (see ❦3.5). In some cases it cannot be corrected (for example, if the distribution was simply not eligible to be rolled over). If the deemed distribution is not corrected, see ❦2.5. Here are other features of the deemed distribution resulting from a failed Roth conversion:

✓ The deemed distribution will normally result in the distribution's being included in the recipient's gross income.

✓ The deemed distribution will be subject to the 10 percent early-distribution penalty if the individual is under age 59½ and no exception applies. See SCA 2001-48051 and ❦2.7.

✓ The deemed distribution apparently does satisfy the minimum distribution requirement. See Reg. § 1.408A-4, A-6.

The deemed "regular contribution" to the Roth IRA resulting from a failed Roth conversion is almost always going to be either entirely or partly an excess contribution. See SCA 2001-48051 and ❦2.2.

❦2.2 Penalty for Excess IRA Contributions

Any amount that is contributed to an IRA (or Roth IRA) falls into one of two categories: Either it is a "rollover" contribution or it is a "regular" contribution:

- A "rollover contribution" is one that meets the requirements applicable to a rollover; for example, the direct transfer of an eligible rollover distribution from a nonIRA plan to an IRA by the participant, surviving spouse, or nonspouse "designated beneficiary" is a rollover contribution. A 60-day rollover of an eligible rollover distribution from a nonIRA plan or IRA by the participant or surviving spouse is a rollover contribution.

- A "regular contribution" is any IRA contribution that does not meet the requirements of a valid rollover.

- Finally, a direct plan-to-plan transfer from one IRA to another IRA of the same type, where both accounts are of the same type (i.e., Roth or traditional), and where both IRAs are beneficially owned by the same person (i.e., the participant or beneficiary) is not considered either a distribution, a rollover, or a contribution for this purpose. Rev. Rul. 78-406, 1978-2 CB 157.

Regular IRA and Roth IRA contributions are limited:

✓ Who can contribute: First, there are limits on who can contribute; for example, an individual cannot make a regular contribution to a traditional IRA in the year he reaches age 70½ or any later year. An individual cannot make a regular contribution to a Roth IRA in a year in which his income exceeds certain amounts. § 408A(c)(3).

✓ How much can be contributed: Second, an eligible individual cannot contribute more than a certain dollar amount in one year to all his IRAs (including Roth IRAs) collectively (or more than his "compensation" income, if less). § 408A(c)(2). The dollar limit for 2014 IRA contributions was $5,500 ($6,500 if age 50 or older).

These limits and requirements generally do not apply to *rollover* contributions, which have different rules and requirements.

There is an excise tax of six percent imposed on "regular" contributions to IRAs and Roth IRAs in excess of the applicable limits. § 4973(a), (f); Reg. § 1.408A-3, A-7. The only way to avoid the tax is to have a timely "corrective distribution" of the excess contribution; see ❦3.1. If the problem is not cured by a timely corrective distribution, then the six percent tax is imposed *annually* on the excess contribution until it is either withdrawn or "absorbed." See ❦3.2–❦3.3.

Where to read more: See ❦4.4 for discussion of rollovers and plan-to-plan transfers. See ¶ 5.3.02–¶ 5.3.04 of *Life and Death Planning for Retirement Benefits* regarding the eligibility requirements for IRA contributions. For the annual limits on IRA contributions, consult the highly recommended *Appleby's IRA Quick Reference Guides* (www.applebyconsultinginc.com) (see Appendix A).

❦2.3 Deemed Distributions

One of the bad things that can happen to a retirement plan is that money the participant or beneficiary thought was *in* a retirement plan turns out to be *outside* any plan. One of the ways an "unwanted out" can occur is with a "deemed distribution."

Generally, retirement plan benefits are not includible in the gross income of the participant or beneficiary until such time as the benefits are actually distributed out of the plan. § 402(a); § 408(d)(1); § 403(b)(1). However, certain actions or conditions can cause funds in a retirement plan

to be "deemed" distributed even without an "actual" distribution. A deemed distribution has several results:

✓ The recipient of the deemed distribution from a traditional retirement plan will have to include the entire deemed distribution (minus any "basis" he may have in the plan that can be applied to the deemed distribution) in his gross income. If the deemed distribution comes from a Roth IRA, see ¶ 5.2.03 of *Life and Death Planning for Retirement Benefits* for tax treatment.

✓ If the deemed distribution occurs during the participant's life and while he is under age 59½, it will be subject to the premature distributions penalty unless an exception applies; see ❦2.7.

✓ Finally, the funds lose the shelter of being inside a retirement plan, so there will be no further tax-deferred accumulation of the investment income (or tax-free accumulation, in the case of Roth plan).

The worst thing about a deemed distribution is that there may be no way to correct the situation and get the money back into the shelter of a retirement plan. See ❦3.4.

Here are the events that cause retirement benefits to be "deemed" distributed to a participant or beneficiary *without* an actual distribution; see also ❦2.8 (prohibited transactions).

A. Pledging an IRA as security for a loan

"If, during any taxable year of the individual for whose benefit an individual retirement account is established, that individual uses the account or any portion thereof as security for a loan, the *portion so used* is treated as distributed to that individual." § 408(e)(4) (emphasis added); see also Reg. § 1.408-4(d)(2). The IRS has allowed an exception to this rule for a pledge of IRA assets to secure a former employee's obligation to repay a pension plan distribution under certain circumstances; PLR 2006-06051.

B. Other assignments, pledges, or transfers

Generally, assigning, pledging, or transferring an IRA or other retirement plan to another person causes a deemed distribution of the account. See § 72(e)(4)(A)(ii); Regs. § 1.408-4(a)(2), § 1.408A-6, A-19; and *Coppola v. Beeson*, 2005-2 USTC ¶50,503, 96 AFTR 2d 2005-5375 (5th Cir. 2005) (participant's pledge of his 403(b) account, as security for alimony he owed, treated as a distribution). Be aware of the following exceptions and possible exceptions to the general rule:

- Regarding transfer of an IRA to a "grantor trust," see ¶ 4.6.03(C) and ¶ 6.1.06 of *Life and Death Planning for Retirement Benefits*.

- The transfer of the account from the participant to the beneficiary that occurs as a result of the participant's death is not a taxable event.

- An individual can transfer all or part of his qualified retirement plan benefits to his spouse without being liable for income taxes on the transfer if the transfer is pursuant to a "qualified domestic relations order" (QDRO). § 402(e)(1), § 414(p). § 408(d)(6) allows similar tax-free division of an IRA between divorcing spouses. In both cases, the statutory requirements applicable to the state court order must be strictly followed. It is not clear whether the QDRO/408(d)(6) procedures for tax-free division of retirement benefits between spouses can be used for *inherited* benefits. This Outline does not cover divorce-related divisions of retirement plans; see, instead, Chapter 36 of *The Pension Answer Book* (Appendix A).

- Regarding transfer of an inherited retirement benefit from a trust or estate to the beneficiary(ies) of the trust or estate, see ¶ 6.5.07–¶ 6.5.08 of *Life and Death Planning for Retirement Benefits*.

C. IRA acquires collectible

The acquisition by any IRA (or by a self-directed account in a QRP) of a "collectible" (as defined in § 408(m)(2)) is treated as a distribution of the cost of the "collectible." § 408(m)(1).

❦2.4 Plan Loan Problems

A participant cannot borrow money from his IRA; such a loan would be a "prohibited transaction" (see ❦2.8), triggering a deemed distribution of the account. § 408(e)(2).

Qualified retirement plans (QRPs) are permitted to make loans to employees from their plan accounts provided various requirements are met regarding the maximum amount of the loan and the repayment terms. § 72(p)(2). For explanation of these requirements, see Chapter 14 of *The Pension Answer Book* (Appendix A).

A plan loan that meets the requirements of § 72(p)(2) is not treated as an income-taxable distribution at the time it is made. However, a plan loan can generate a "deemed distribution" or an "offset distribution." These two types of distributions have very different consequences; when the "distribution" results from a default under the loan it is not always clear which type it is (deemed or offset). A "deemed distribution" cannot be rolled over, and thus a deemed distribution is a mistake that cannot be fixed. It's a chute without any ladder. An "offset distribution," however, CAN be rolled over. Here are the details:

A. Deemed distribution caused by "flunking" § 72(p)

If the loan does *not* meet the requirements of § 72(p) (either from the beginning, or because the employee later fails to meet the statutorily required repayment terms) the loan (or, if the problem is that the loan exceeded the permitted amount, the excess part of the loan) is treated as a deemed distribution to the employee. § 72(p)(1)(A). If, after the loan was treated as a deemed distribution, the employee does in fact repay the loan, then such repayments to the plan are treated as after-tax

contributions to the plan for purposes of computing the employee's basis (investment in the contract). Reg. § 1.72(p)-1, A-4, A-10, A-11, A-21. A deemed distribution under § 72(p):

- Is not an eligible rollover distribution; Reg. § 1.402(c)-2, A-4(d).
- Cannot be a tax-free "qualified distribution" if made from a designated Roth account (DRAC) in a 401(k), 403(b), or 457(b) plan (see ¶ 5.7.04(C) of *Life and Death Planning for Retirement Benefits*); Reg. § 1.402A-1, A-2(c).
- Does not count towards fulfilling the minimum distribution requirement. Reg. § 1.401(a)(9)-5, A-9(b)(4).
- Is subject to the 10 percent early distributions penalty if the participant is under age 59½ and no exception applies; see ❦2.7.

B. Plan loan offset distributions

If the loan *complies* with § 72(p), we get away from the nonrollable deemed distribution that occurs when § 72(p) is violated. We then encounter another type of loan-related distribution, the "plan loan offset distribution" that occurs when the employee's termination of employment (or death) causes the loan to be accelerated. Typically, the plan requires the loan to be repaid immediately in that event, deducts the loan balance from the employee's account, and distributes to the employee (or beneficiary) the plan benefits minus the loan amount. The plan's repayment to itself is called a loan offset, and it is considered an actual distribution, includible in gross income when the offset occurs (except to the extent it is rolled over). Reg. § 1.72(p)-1, A-13. As an "actual distribution," the plan loan offset:

- ✓ Does count towards the required minimum distribution (RMD) (if any) for the year. Reg. § 1.401(a)(9)-5, A-9(a).
- ✓ Is subject to the 10 percent early distributions penalty (§ 72(t)), unless an exception applies (see ❦2.7). For example, if the employee has retired at age 55 or later at the time the plan loan offset distribution to him occurs, there is no penalty. § 72(t)(2)(A)(v), (3)(A).
- ✓ Is an eligible rollover distribution, except to the extent it represents a required minimum distribution (RMD). The participant can "roll over" the non-RMD portion of the offset distribution using substituted funds. Reg. § 1.402(c)-2, A-9; PLR 2006-17037; IRS Instructions for Forms 1099-R and 5498 (2011), p. 3. See *Tilley v. Comm'r*, T.C. Summary 2008-86, in which the Tax Court ruled that, for purposes of computing the 60-day rollover deadline, the offset distribution was deemed to have occurred upon expiration of the loan's 90-day cure period. See PLR 2009-30051, in

which an employee was granted a hardship waiver (see ❦3.5) of the 60-day rollover deadline for a plan loan offset distribution.

✓ Is treated as an "eligible rollover distribution" (or as part of such a distribution) for purposes of the mandatory 20 percent income tax withholding on eligible rollover distributions. However, the plan is not obligated to withhold more than the cash (i.e., the non-offset) portion of the distribution. Reg. § 31.3405(c)-1, A-11. The plan does not have to offer the "direct rollover" option for an offset distribution as it does for other eligible rollover distributions. Reg. § 1.401(a)(31)-1, A-16.

C. Who gets the "offset" when participant dies?

If the decedent had borrowed money from his employer's QRP, the plan will typically "pay itself back" out of the employee's account before distributing the (net amount) to the beneficiary of the account, thereby creating a "plan offset distribution" (see "B" above) and its resulting phantom income.

The question is, *to whom* is the offset amount deemed distributed in this case? One possibility is that this is considered a distribution *to the participant's estate*, because it is discharging a debt of the decedent. Another view is that this is a distribution to the beneficiary(ies) of the account. Reg. § 1.402(c)-2, A-9(a), seems to support the "beneficiary" view, since it says that the plan offset distribution "can be rolled over by the employee *(or spousal distributee)*." Emphasis added. There is no other guidance.

Where to read more: For more on the subject of what is or is not an "eligible rollover distribution," see ¶ 2.6.02 of *Life and Death Planning for Retirement Benefits*. For mandatory income tax withholding on certain nonIRA retirement plan distributions, see ¶ 2.3.02(C). Regarding the option of a "direct rollover" from a nonIRA plan, see ¶ 2.6.01(C).

❦2.5 Other "Unintended Distributions"

❦2.3 and ❦2.4 primarily dealt with various "deemed" distributions, where money was deemed to be distributed from a retirement plan even though the money was still in the plan. This section deals with *actual* distributions that were either not intended to occur at all or that were intended to be replaced safely inside a retirement plan, so they were not intended to stay outside, such as:

✓ An invalid rollover; a rollover where, even though the "rolled" money ends up inside a retirement plan, the transfer does not qualify for tax-free rollover treatment. That is treated as a distribution from the first plan, followed by a regular contribution to the recipient plan. See ❦1.1–❦1.8 and ❦2.2.

✓ The participant believes he has successfully opened, or placed money in, a retirement account, but the funds never actually got into such an account. See ❦1.10(A).

The punishment for the unintended distribution is that the distribution is taxable (unless it is a qualified distribution from a Roth IRA, or to the extent the recipient has "basis" [investment in the contract] to offset the income); the distribution is subject to the 10 percent penalty if the recipient is under age 59½ unless an exception applies (see ❦2.7); and the participant or beneficiary has lost the benefit of continued tax-deferred or tax-free investing inside a retirement plan.

The remedy for an unintended distribution is (if the recipient and distribution are eligible) a rollover, to "erase" the distribution; see ❦3.4 and ❦3.5. Also see ❦3.9 ("undistributing").

❦2.6 Punishments for Failure to Distribute the RMD

Compliance with the minimum distribution rules is one of the more than 30 requirements a qualified retirement plan (QRP) must meet to stay "qualified." § 401(a). The plan administrator is the enforcer of the QRP minimum distribution rules. Since disqualification of the plan would be a disaster for all concerned, the plan administrator is extremely concerned to make sure RMDs are distributed—even though the penalty for missing an RMD is imposed on the "payee" rather than on the plan.

An IRA does not have to be "qualified" in the same way that QRPs must be qualified; the IRS does not issue individual determination letters for IRAs. Rev. Proc. 87-50, 1987-2 C.B. 647, § 4.03; see Rev. Proc. 2010-48, 2010-50 IRB 828. The penalty tax for failure to take the RMD falls on the payee, not on the IRA provider. § 4974(a).

However, IRA providers are required to report to the IRS annually, on Form 5498, the prior year-end account value of each IRA they hold and also whether an RMD is required from the account for the current year. Reg. § 1.408-5. The IRA provider is also required to inform the IRA account holder that a distribution is required, and to either calculate or offer to calculate the amount of the RMD for the account holder. Reg. § 1.408-8, A-10; Notice 2002-27, 2002-1 CB 814.

The Code imposes a penalty for failure to take an RMD. The penalty is 50 percent of the amount that was supposed to be, but was not, distributed. § 4974(a). For how to compute the penalty, see Reg. § 54.4974-1.

The penalty is imposed on the "payee" (nonpayee?). § 4974(a). Presumably, in the case of a single IRA left to multiple beneficiaries, each beneficiary is liable for a penalty only to the extent he fails to take *his particular share of the distribution*, though there is no authority or guidance on this point.

An *individual participant or beneficiary* who has failed to take an RMD (or failed to take the full amount of the RMD) must file Form 5329 for each year for which an RMD was wholly or partly missed. If he hasn't yet filed his income tax return for the year the distribution was missed, and he is required to file a return for that year, the Form 5329 should be attached to the return (Form 1040; you cannot use Form 1040A or 1040EZ if you must file Form 5329). However, if he already has filed his tax return for the year the distribution was missed, or if he is not required to file a return for that year, he should file Form 5329 as a stand-alone form. He does not need to file an amended income tax return (Form 1040X) if there are no other changes to the originally-filed return. See Reg. § 301.6501(e)-1(c)(4) and instructions for IRS Form 5329 (2013), p. 1.

If the *fiduciary* of a trust or estate fails to take an RMD that should have been paid to the trust or estate (as beneficiary of an inherited IRA), the fiduciary should attach Form 5329 to the estate's or trust's Form 1041; see instructions for IRS Form 1041 (2013), p. 32 (Schedule G, line 7).

When an RMD is not taken in the Distribution Year to which it is attributable, it is added to and considered part of the RMD for the next Distribution Year *for purposes of determining whether distributions in the subsequent year are eligible for rollover*. Reg. § 1.402(c)-2, A-7(a) (last sentence). (RMDs are not "eligible rollover distributions"; see ❦1.1.) However, it does not appear that the missed RMD is subject to the 50 percent extra tax in more than one year; see IRS Form 5329 (2011), lines 50–51, and Instructions (pp. 6-7). Presumably, despite the "carryover" rule, if an RMD was missed in only one year, Form 5329 needs to be filed only for that year, not for all subsequent years until it is taken.

If an RMD has been missed, do you deduct the missed RMD from the "prior year-end account balance" when computing the RMDs for *subsequent* years? That is a "reasonable and appropriate" way of computing such later-year RMDs, at least for a qualified retirement plan, according to Reg. § 1.401(a)(9)-5, A-3, and Rev. Proc 2013-12, "Employee Benefit Plan Qualification Requirements—Employee Plans Compliance Resolution System," 2013-4 I.R.B. 313 (12/31/12), Appendix A ("Operational Failures and Correction Methods"). Presumably this also applies to IRAs, though there is no separate IRS pronouncement on that subject.

In general, the IRS must assess taxes within three years after a required return for those taxes was filed—and there is *no* statute of limitations if no return is filed. § 6501(a), (c)(3). The goal of participants and beneficiaries should be to assure themselves the protection of the three-year statute of limitations with respect to assessment of the 50 percent penalty tax for missed RMDs under § 4974. The following discussion explores the statute of limitations applicable to IRS claims for a penalty for a missed RMD:

A. What is the "return" you have to file?

The penalty for failure to take a required distribution is imposed by § 4974, which is part of Subtitle D ("Miscellaneous Excise Taxes") of the Code. In the case of an excise tax such as that under § 4974, "the filing of a return" for the applicable period "on which an entry has been made with respect to a tax imposed under a provision of subtitle D (including a return on which an entry has been made showing no liability for such tax for such period) shall constitute the filing of a return of all amounts of such tax which, if properly paid, would be required to be reported on such return for such period." § 6501(b)(4).

A "return" for this purpose means "the return required to be filed by the taxpayer."

One might conclude that just filing the annual income tax return, Form 1040, with a "zero" entry on the line for "Additional tax on IRAs, other qualified plans, etc.", could be sufficient to start the statute of limitations running. However, in the case of the 50 percent penalty tax, the "return" is Form 5329 according to Reg. § 301.6501(e)-1(c)(4); Instructions for IRS Form 5329 (2013), p. 1; and *Robert K. Paschall et ux. v. Comm'r,* 137 T.C. 8 (7/5/11).

B. How to avoid the six-year statute

§ 6501(e)(3) provides that a *six-year* statute of limitations applies to Subtitle D taxes (which would include this penalty) "if the return omits an amount of such tax properly includible thereon which exceeds 25 percent of the amount of such tax reported thereon." If the taxpayer files a Form 5329 or 1040 showing zero as the amount of excise tax he owes, and the IRS later decides some tax was owed, it is obvious that the amount "omitted" will always be more than 25 percent of the amount shown on the return.

The Code provides a way out of this problem. "In determining the amount of tax omitted on a return, there shall not be taken into account any amount of tax…which is omitted from the return if the transaction giving rise to such tax is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the existence and nature of such item." § 6501(e)(3). Therefore, to keep the statute of limitations at three years instead of six years, one would need to file (in addition to a return showing "zero" penalty owed) a description of the "item" in the "return (or in a schedule or statement attached thereto) in a manner sufficient to apprise the district director…of the existence and nature of such item." Reg. § 301.6501(e)-1(c)(4).

Accordingly, to minimize exposure to possible penalties, all participants over age 70½, and all beneficiaries (including trusts or estates named as beneficiaries) holding inherited retirement benefits, should file Form 5329 every year, even when they believe they owe no penalty, and attach a statement to the return listing the retirement plans owned by the taxpayer, his age, and other relevant facts, and explaining how the RMD was calculated (or why no RMD was required). Proceeding in this fashion should assure that the three-year statute of limitations (not the six-year statute…and not *no* statute) applies to any missteps with respect to required minimum distributions.

❦2.7 10 Percent Penalty for Early Distribution [topic not covered in this Outline]

§ 72(t) imposes a 10 percent penalty on retirement plan distributions made to a participant who is younger than age 59½. Generally, the penalty applies only to the portion of the distribution includible in the participant's gross income. There are 14 exceptions (cases in which funds can be withdrawn from a plan with no penalty despite the recipient's young age).

To learn about this penalty, see Chapter 9 of *Life and Death Planning for Retirement Benefits* which explains the penalty and its exceptions. A free resource is IRS Publication 590 ("IRAs").

❦2.8 Prohibited Transaction with an IRA

Engaging in a "prohibited transaction" with your IRA causes the entire account to lose its qualification as an IRA, and to be treated as distributed as of the first day of the year in which the prohibited transaction occurred; see "A" below.

Do not engage in a prohibited transaction involving your IRA. To avoid prohibited transaction problems, make sure that the IRA never enters into *any* transaction with the IRA owner (other than accepting legal contributions and making permitted distributions), or any person or entity related to the IRA owner, or any person or entity with whom or with which the IRA owner has any

type of business or personal relationship outside of the IRA; and that the IRA owner never engages in any transaction *outside* the IRA that involves a payment in connection with assets *inside* the IRA.

A. The penalty for an IRA prohibited transaction. The penalty on an IRA owner (or beneficiary) for "engaging" in a prohibited transaction involving the IRA is that the account ceases to be an IRA and is deemed to have been entirely distributed to him on January 1 of the year in which the transaction occurs. § 408(e)(2); Reg. § 1.408-4(d)(1). The result is that the individual must pay income tax on the account value just as if it had been distributed to him. The same rule applies to a Roth IRA. § 408A(a); Reg. § 1.408A-1, A-1(b).

B. Transactions that are prohibited. Prohibited transactions include just about any direct business transaction (such as sale, leasing of property, payments for goods or services, lending of money or property, "extension of credit," etc.) between the IRA and a disqualified person (see "C" below). § 4975(c)(1)(A)–(D). These transactions are prohibited transactions *even if the plan is not harmed*. For example, a participant's bargain sale of property to an IRA would be a prohibited transaction even though the IRA is getting a good deal. Here are some recent examples of IRA prohibited transactions:

In Advisory Opinion 2011-04A (2/3/11), http://www.dol.gov/ebsa/regs/aos/ao2011-04a.html, the DOL ruled that an IRA could not purchase, from an unrelated party (a bank), a promissory note on which the IRA owner and his spouse (the IRA beneficiary) were the obligors. A loan exists until it is paid off, said the DOL, therefore the IRA's ownership of a note signed by the IRA owner was a prohibited extension of credit between the IRA and a disqualified person, even if the note was acquired in an arm's length transaction from an unrelated party.

In two recent opinions, the DOL found that standard brokerage firm "boilerplate" paperwork gave rise to prohibited transactions. The DOL ruled in 2009-03A (10/27/09), http://www.dol.gov/ebsa/regs/aos/ao2009-03a.html, that a participant who signed a standard brokerage firm form that granted the IRA provider a security interest in the participant's nonIRA account at the same firm, to secure any liabilities to the firm that his proposed new IRA account at the firm might incur, was committing a prohibited transaction, namely, the extension of credit between the IRA and the IRA owner (§ 4975(c)(1)(B)). Similarly, in 2011-09A (10/20/11), http://www.dol.gov/ebsa/regs/aos/ao2011-09a.html, the DOL opined that an IRA owner who signed an agreement whereby a brokerage firm was given a security interest in the IRA assets to secure the participant's potential future liabilities under a (taxable) futures trading account that the participant proposed to open at the same firm, would be engaging in a prohibited extension of credit, and that this prohibited transaction was not covered by a "class exemption" previously granted to extensions of credit in connection with routine plan operating costs. These two DOL opinions have stirred up such a ruckus that the IRS has issued a blanket exemption for these transactions, provided that the cross guarantees are not actually activated (see IRS Announcement 2011-81), and the DOL is supposedly mulling issuing a class exemption.

There are other ways to have a prohibited transaction besides these catalogued transactions between the IRA and a related party. An IRA transaction with a party who is *not* a disqualified person can be a prohibited transaction if it *indirectly benefits* a disqualified person. § 4975(c)(1)(E),

(F). This rule has been used to find a prohibited transaction when a plan or IRA engaged in transactions with entities that were *less than 50 percent owned* by disqualified persons; even though the entity was therefore not a disqualified person (see "C"), the transaction was found to *indirectly benefit* disqualified persons who were minority owners of (or otherwise related to) the entity. *Rollins*, T.C. Memo 2004-260 (2004); PLR 9119002; DOL Advisory Opinion 93-33A.

A transaction in which the IRA is *not even involved* could be a PT; for example, if the IRA owner receives a payment, outside the IRA, for a transaction involving the IRA's assets. § 4975(c)(1)(F). The IRS and DOL have even been known to claim that any transaction involving a conflict of interest between the IRA and the owner as "fiduciary" is, itself, a PT, without (apparently) the necessity of proving that any disqualified person benefitted from the transaction, though this IRS/DOL position has not been tested in court. See Reg. § 54.4975-6(a)(5)(i), DOL Advisory Opinion 2000-10A.

Finally, if the IRA owns or controls an entity, a disqualified person's transaction with or involving the IRA-controlled entity may be a prohibited transaction under a set of look-through rules called the "plan asset rules." See 29 CFR § 2510.3-101(a)(1), (f)(2)(ii); DOL Advisory Opinion 2000-10A.

C. **Who are disqualified persons?** Disqualified persons include the IRA owner (who is considered a "fiduciary" of his own IRA) and certain related parties, namely, the IRA owner/fiduciary's spouse, ancestors, descendants, and spouses of descendants. An entity that is controlled or more than 50 percent owned by disqualified persons (after application of attribution rules) is also a disqualified person. § 4975(e)(2). Under the "plan assets rule" (see "B" above), managers of a plan-owned entity are also considered fiduciaries and thus are disqualified persons.

D. **Exemptions.** Certain transactions necessary for an IRA to function are either explicitly exempted or assumed to be exempt, such as making legally permitted contributions to the IRA; taking distributions from the IRA (§ 4975(d)(9); see DOL AO-2009-02A); naming or changing the designated beneficiary; and dividing the IRA in the case of divorce (see PLRs 2002-15061 and 2011-50037). The Department of Labor has granted certain "class" exemptions to permit some standard transactions, such as (in the case of qualified retirement plans or "QRPs") the employee's purchase of life insurance from the plan, and (in the case of an IRA) using the IRA balance as part of a collection of accounts to meet a minimum balance requirement (PTE 93-2, PTE 93-33). The DOL can also grant an individual exemption for a proposed transaction, and can issue an "Advisory Opinion" about whether a proposed transaction is a PT. See http://www.dol.gov/ebsa/compliance_assistance.html.

E. **Enforcement of the prohibited transaction rules.** The best hope for clients and advisors who come too close for comfort to the prohibited transaction rules is the chaotic state of the prohibited transaction law and its enforcement. The statute contains mistakes (has contained them since 1974!) that make the law nonsensical in some respects. The meaning of certain terms such as "beneficiary" and "engages" have never been clarified. Enforcement of the rules with respect to IRAs was originally granted to both the IRS and the DOL, then (in

1978) was supposedly divided between them, and is now claimed sporadically by both of them, so no one seems to know who is really in charge. The DOL and Courts have issued rulings that appear incorrect. The IRS has issued contradictory rulings on prohibited transactions, and is generally so uncomfortable with this area that it tends to use anything other than prohibited transactions to attack transactions, such as gift taxes, § 482, improper IRA contributions, and listed transactions.

F. **Recommendations for advisors.** Promoters and planners look for flaws in the prohibited transaction rules that they can exploit to allow the IRA owner to engage in various transactions generally designed to maximize the advantage of investing inside a tax-deferred IRA or tax-free Roth IRA. Hopes have been pinned on such notions as that the prohibited transaction rules do not apply on formation of an entity; that the IRA owner is not a disqualified person if he can be positioned so that he is not a "fiduciary" of the IRA; and that any transaction with an in-law, sibling, or nonspouse significant other is not a prohibited transaction because those persons are not disqualified persons.

It is not recommended that a client rely on such approaches. It is recommended that the estate planner not "dabble" in prohibited transactions. If involved with a transaction that may raise prohibited transaction questions, the estate planner should either hire or become an expert. To get started, see Chapter 24 of *The Pension Answer Book* (Appendix A). Another resource is the author's *Special Report: Buyer Beware! Self-Directed IRAs and Prohibited Transactions*, downloadable at www.ataxplan.com. No estate planner should advise regarding a transaction between an IRA and any related party unless (1) there is a class exemption that clearly applies, or (2) the planner devotes the time to study the applicable rules, or (3) an ERISA expert gives an opinion that the prohibited transaction rules are not violated. Another approach is to follow the Department of Labor and IRS procedures for getting an Advisory Opinion (DOL), prohibited transaction"exemption" (DOL or IRS), or private letter ruling (IRS).

Since the potential penalty for a prohibited transaction involving the IRA owner or beneficiary is disqualification of the IRA, use one IRA for the proposed transaction and a different IRA to hold the owner's other, less controversial, investments. If the separation of the two accounts occurs prior to the year in which the questionable transaction occurs, a prohibited transaction in one account presumably would not put the other IRA at risk.

III. THE LADDERS: WAYS TO FIX THINGS

The Code and IRS regulations provide many escape hatches for the nasty spots that IRA owners can find themselves in.

❦3.1 IRA Contributions Returned Before Tax Return Due Date

The Code allows IRA contributions to be returned to the contributor for a certain period of time. If three requirements are met (see A–C), the returned contribution gets special treatment for income tax purposes (see "D"), for purposes of the 10 percent penalty on premature distributions (see

"E"), and for purposes of the penalty on excess IRA contributions (see "F"). In this Outline, a returned IRA contribution that meets these requirements is called a "**corrective distribution**," regardless of whether it was returned in order to correct a problem (such as an excess IRA contribution) or just because the participant changed his mind. The Code and the IRS call these "contributions returned before due date of return"; see § 408(d)(4) and IRS Publication 590 (*IRAs*) 2011, p. 30.

The same rules apply to return of *Roth* IRA contributions. Reg. § 1.408A-6, A-1(d).

If an excess IRA contribution is returned late, so it does not qualify as a corrective distribution, see ❦3.2 and ❦3.3.

A. Deadline for a corrective IRA distribution

To qualify for the special income tax treatment (see "D"), the corrective distribution must be "received on or before the day prescribed by law (including extensions of time) for filing such individual's return for such taxable year." § 408(d)(4)(A). The return of an IRA contribution is apparently considered an "election" of the type that qualifies for the "automatic" extension of the deadline to October 15 of the year following the year in question if the individual's income tax return is timely filed. Accordingly, the participant who makes an IRA contribution in "Year 1," can either: withdraw the contribution and its earnings before April 15, Year 2; obtain an extension of time to file the return until October 15, Year 2, and (provided he actually files the return by that extended deadline) withdraw the contribution by October 15, Year 2**;** or withdraw the contribution (by October 15, Year 2) *after* he has already filed his return on time and then file an amended return. See ❦4.1.

B. Income attributable to returned IRA contribution

The amount that must be distributed by the deadline is the contribution itself, "accompanied by the amount of net income attributable to such contribution." § 408(d)(4)(C). For how to compute the net income attributable to a returned IRA contribution, see ❦4.2.

C. No deduction taken

The participant must not take an income tax deduction for the contribution. § 408(d)(4)(B). If he has already filed the return and taken a deduction (see "A" above) he must file an amended return to un-take the deduction.

D. Income tax treatment

The general rule for income tax treatment of IRA distributions (under § 408(d)(1) and § 72) is that any such distribution is included in gross income to the extent it exceeds the distributee's basis (or "investment in the contract"). Any distribution is treated as carrying out proportionate amounts of the participant's basis and the earnings thereon, with all IRAs being treated as a single account (aggregated) for purposes of determining that proportion. The proportionate rule has been nicknamed the "cream-in-the-coffee rule": The basis (after-tax money) is the cream and the earnings

(pretax money) are the coffee, and each "sip" (distribution) carries out some of each. Returned IRA contributions are an exception to these general rules: If the above three requirements A–C are met, the corrective distribution is not taxable under § 408(d)(1), and therefore is not taxable under § 72, so the cream-in-the-coffee rule does not apply.

Rather, apparently, the distribution is taxable only under § 61, which is the general definition of gross income. Accordingly, it appears that the returned contribution itself is not taxable (because it is not "income"); only any net income "attributable" to the contribution that is distributed with it (see "B" above) would be taxable. § 408(d)(4) provides that "for purposes of section 61, any net income [that is attributable to the contribution and accordingly is included in the distribution] shall be deemed to have been earned and receivable in the taxable year in which such contribution is made." Reg. § 1.408A-3, A-7, § 1.408A-6, A-1(d).

E. 10 percent penalty treatment

Because the returned contribution itself is not taxable under § 72 (see "D" above), it is not subject to the 10 percent penalty that is imposed on pre-age-59½ distributions by § 72(t) (see ❦2.7).

However, according to the IRS the net income that is returned with the contribution (see "B" above), which is income-taxable (see "D" above), is *also* subject to the 10 percent penalty if the participant is *under age 59½ at the time he withdraws the contribution*, unless an exception applies. Notice 87-16, 1987-1 C.B. 446, Question C2; *Hall*, T.C. Memo 1998-336.

Wayne Example: Wayne, age 50, was eligible to, and did, contribute $3,000 to a new IRA (one that contained no other funds) in 2009. Wayne made no other contributions to, and took no distributions from, the IRA. By 2010, the investments in the IRA had earned $75 of interest. Wayne then cashes out the account in March 2010, prior to the due date of his 2009 tax return, receiving a distribution of $3,075. The $75 of earnings are included in his gross income for the year of the contribution (2009), *not* the year they are distributed (2010), and the 10 percent penalty ($7.50) is payable for the year 2009 unless an exception applies.

I Disagree with the IRS

In my opinion, the 10 percent penalty should not apply to the earnings distributed as part of a corrective distribution. A corrective distribution is not taxed as a retirement plan distribution. For example, it is not subject to the "cream-in-the-coffee rule" and it is not apparently treated as a distribution for purposes of the rule that the first distribution of the year "counts" as the required minimum distribution (see Reg. § 1.402(c)-2). The purpose of the penalty is to prevent people from taking advantage of the tax-deferred or tax-free accumulation of funds inside the IRA then using the money prematurely (before retirement age). But the funds distributed in a corrective distribution are treated as never having been contributed, the earnings must be distributed along with the contribution, and the earnings are taxed in the year the contribution was made, so there has been no tax-deferred or tax-free accumulation that the participant needs to be "punished" for taking advantage of!

F. Effect on six percent penalty

A six percent penalty applies to excess IRA and Roth IRA contributions; see ❦2.2. A corrective distribution that meets the requirements of § 408(d)(4) (see A–C above) is treated "as an amount not contributed" for purposes of this penalty. Thus, making a corrective distribution that meets the requirements of § 408(d)(4) gets the participant not only a special income tax dispensation, but also excuses him from the six percent penalty. § 4973(b) (second to last sentence), § 4973(f) (last sentence).

G. Corrective distribution example

Lola Example: Lola's father died in 2009, leaving his $300,000 401(k) plan (all pretax money) to Lola (age 48) as Designated Beneficiary. In 2010, Lola requested the plan administrator of the 401(k) plan to transfer the inherited 401(k) benefit to an "inherited IRA." Due to an error by the financial institution, the funds were transferred into Lola's *own* IRA (one she owned as participant), not into an *inherited* IRA. Because the distribution was not properly rolled over pursuant to the requirements of § 402(c)(11), the $300,000 distribution from the 401(k) plan is included in Lola's gross income for 2010. The transfer of funds into her own IRA is considered a "regular contribution" to that account (see ❦4.3). Assume the maximum regular contribution Lola can legally make to her own IRA in 2010 is $5,000, so $295,000 of this improper rollover is an *excess contribution*. Lola must withdraw that excess contribution (and all net income attributable to it; assume the "income attributable" is $12,000) no later than October 17, 2011, to avoid being liable for a six percent penalty ($17,700) on the $295,000 excess contribution. See ❦2.2, ❦3.1. Assume she withdraws the excess contribution and income thereon in early 2011. Here is how she will report these transactions on her 2010 tax return: She will include in gross income a $300,000 distribution from the inherited 401(k) plan in 2010 (though includible in her income in 2010, this distribution is not subject to the 10% penalty because the penalty does not apply to death benefits; § 72(t)(2)(A)(ii)); additional income of $12,000 (the earnings on the contribution) reportable in 2010 and subject to the 10% penalty in 2010 (see "D" and "E" above); and a $5,000 "regular" contribution to her own IRA for 2010.

❦3.2 Quasi-Corrective Distributions

❦3.1 explained how to avoid the six percent penalty on excess IRA contributions by making a timely "corrective distribution" of the excess contribution and the earnings thereon. If the problem is not corrected by a timely "corrective distribution," the contributor owes the penalty for the year the excess contribution occurred.

But the excess contribution penalty is not limited to that one year. It keeps accruing annually until the problem is fixed. So now we will look at the ways to reduce or avoid the penalty for years *after* the year of the original contribution.

If an individual makes contributions to his IRA for a particular year, and the combined total amount of such contributions is *within the Applicable Dollar Limit for that year*, but the individual is not eligible to contribute to the IRA in such year (for example, because he did not have sufficient

compensation income, or [in the case of a traditional IRA] because he was too old), and this excess contribution (together with earnings thereon) is *not* returned to him in time to be a corrective distribution (see ❦3.1(A)), he will owe the penalty for the year the excess contribution occurred, but (as long as he did not take a deduction for the contribution) it can be returned to him tax-free even *after* the normal corrective-distribution deadline. § 408(d)(5); see Instructions for IRS Form 8606 (2011), pp. 4–5 ("Return of Excess Traditional IRA Contribution").

If the individual does not qualify for this special deal, see the next section for the more "normal" treatment of a late-returned excess IRA contribution.

❦3.3 Excess IRA Contributions, cont.: Late return or "Absorption"

A. Income tax effect

If an excess IRA contribution is not returned by the applicable deadline for a proper corrective distribution (see ❦3.1) the income tax treatment and the penalty treatment *both* change. Except for the limited escape hatch described in ❦3.2, *there is no special income tax "deal"* for an excess IRA contribution that has not been withdrawn by the applicable deadline for a timely corrective distribution. Unless the excess contribution can be "absorbed" into the following year's IRA contribution (see "C"), the participant should still withdraw the excess contribution (to avoid accruing *additional* annual excess-contribution penalties), but such withdrawal will be taxed under the usual cream-in-the-coffee rule (see above) unless the limited exception described at ❦3.2 applies. On the "bright" side, the excess contribution is added to the participant's basis in the IRA. See PLR 2009-04029.

B. Effect on 6% penalty

If the excess contribution was not returned (with its net income) by the applicable deadline in order to be a timely "corrective distribution," the participant owes the six percent penalty for the year the excess contribution occurred. This is true *even if* he qualifies for the special *income tax* treatment described at ❦3.2. The excess contribution is then "carried over" to the next year; and is treated, for purposes of computing the excess contributions penalty for such following year, as if it were a "regular contribution" for such following year, and for each succeeding year, until it is either "absorbed" or distributed. See Reg. § 1.408A-3, A-7. Note that:

- Once the deadline for a corrective distribution has passed, the earnings on the excess contribution cease to be a factor with respect to the excess contributions penalty. The excess contribution is simply carried forward, dollar for dollar, with no growth factor, from year to year, until it is either "absorbed" or distributed (see § 4973(f)(2)). To the extent each additional year goes by without having the excess contribution either fully "absorbed" or distributed, there will be a six percent penalty each year.

- The fact that the participant can eliminate the excess-contributions penalty by merely withdrawing the *contribution* after the corrective-distribution deadline has passed, *without*

withdrawing the earnings that were generated by the excess contribution, creates the potential for an abusive Roth IRA transaction. The participant deliberately makes an excess Roth contribution to a new, separate, Roth IRA (one that does not contain any other funds) early in "Year 1," then waits until early October, Year 2, to see what happens. If the investment of the contribution is disappointing (it fell in value, for example), the participant withdraws the contribution and the earnings on the contribution in order to have a valid "corrective distribution" and avoid the excess contribution penalty. But if the investments in the Roth account have appreciated, he allows the corrective distributions deadline to pass, pays the six percent penalty tax on the amount contributed in Year 1, then withdraws the excess contribution before the end of Year 2 (to avoid incurring a second year's excess contribution penalty)—but leaves the earnings inside the Roth to grow forever "tax free." No IRS pronouncement has yet addressed this situation, but if it becomes a widespread or publicized practice, the IRS is bound to attack it—perhaps by disqualifying any IRA that is intentionally funded with excess contributions, or perhaps by decreeing that earnings on excess contributions cannot be tax-free "qualified distributions" from a Roth IRA.

C. Absorption of excess IRA contribution

An excess IRA or Roth IRA contribution can be "absorbed" as a regular contribution for a succeeding year if the individual who made the excess contribution (1) is eligible to make a regular contribution to that account for such succeeding year and (2) does not use up his regular contribution limit by making a cash contribution for such succeeding year. Of course, the most that can be "absorbed" in any one year is the applicable contribution limit amount for that individual for that year.

D. Late-returned excess contribution example

Armande Example: Armande, age 45, is eligible to contribute $5,000 to a traditional IRA in 2010. By mistake he contributes $9,000. He has made an excess contribution of $4,000. By the time he discovers this error, in early 2011, the $4,000 excess contribution has already generated $3,000 of "net income attributable thereto" due to Armande's spectacular investment success. To avoid a six percent excess contribution penalty for 2010 ($240), he would have to withdraw the $4,000 excess contribution and the $3,000 of "earnings" thereon…but the earnings would be subject to income tax *and* to the 10 percent penalty on "early distributions" (according to the IRS; see ❦3.1(E)) because Armande is under age 59½. So he would have to pay a $300 penalty to avoid a $240 penalty! He decides to pay the excess contributions penalty of $240 for 2010, leave the excess contribution in the IRA, and treat the 2010 excess contribution as part of his $5,000 "regular" IRA contribution for 2011. In 2011 he is eligible to contribute up to $5,000 to an IRA from his compensation income, so the $4,000 excess contribution carried over from 2010 will "absorb" most of his 2011 contribution.

❦3.4 Rollovers: The Miracle Cleanup Machine

If something is distributed out of a retirement plan, and the recipient actually wants that something to stay IN a retirement plan rather than live OUTSIDE the plan, the remedy is a rollover. Certain people are entitled to take certain distributions and, within a certain amount of time, deposit the distribution amount into certain other types of (or even the same) retirement plan account.

If all the steps are carried out correctly, and the distribution and the individual who did the rolling are eligible, and the plan(s) involved are the right types of plan, then the result is a valid rollover. Normally the effect of a valid rollover is that the money is either NOT treated as a distribution from the original plan (so it does NOT have to be reported on the recipient's income tax return for example) or (if the "roll" was from a traditional account to a Roth account) it is a valid Roth conversion (which is taxable); and (either way) it is still in the comfortable tax-free or tax-deferred retirement plan shelter environment.

In certain cases, a plan-to-plan transfer can or must be used instead of an actual "rollover." See ❦4.4 for the differences between rollovers and trustee-to-trustee transfers.

The rollover is the usual remedy of choice for an Unintended Distribution:

Courtney Example: Courtney, age 40, has $10,000 in an IRA with BCD Mutual Fund Company that she wants to transfer to an IRA at EFG Mutual Fund Company. She instructs BCD to send the money directly from her BCD IRA to the IRA she has opened at EFG. When she returns home from a business trip, she opens her bank statement to find that BCD sent the money via direct deposit to her taxable checking account. Courtney has an "unintended distribution" (see ❦2.5). Courtney had not received any other IRA distributions within the preceding 12 months (see ❦1.7). Within 60 days after receiving the unintended distribution, Courtney takes the money out of her checking account and deposits it in her IRA at EFG Company. She has cured the unintended distribution via rollover.

Any distribution from a QRP, IRA, or 403(b) plan may be rolled over except those listed in A–H below.

Before 2002, money could be rolled from a traditional IRA to a QRP or 403(b) plan only if the traditional IRA contained no contributions other than one or more distributions rolled from the same or another QRP or 403(b) plan, so-called "conduit IRAs." See § 408(d)(3)(A)(ii)–(iii), prior to repeal by EGTRRA, and Reg. § 1.408(b)(2), which is now obsolete. Now, pretax money can be rolled from *any* IRA "upstream" to a QRP.

Rollovers can cure the Unintended Distribution problem in the following situations:

✓ If income taxes have been withheld from an **eligible rollover distribution** the participant or surviving spouse can nevertheless roll over the withheld amount by substituting other funds. Reg. § 1.402(c)-2, A-11; see PLR 2003-44024.

✓ If a QRP pays off a participant's plan loan by applying the plan account balance to the loan (i.e., deducting the loan amount from the plan account), the participant or surviving spouse can roll over the entire "offset distribution" using substituted funds. See ❦2.4.

✓ Any case where the Unintended Distribution is an eligible rollover distribution and the recipient is eligible to and does roll it over into an eligible plan within the applicable rollover deadline.

Here is a list of the distributions that may NOT be rolled over:

A. **Inherited plans.** A distribution from an inherited retirement plan may not be rolled over to the beneficiary's *own* plan by any beneficiary other than the participant's surviving spouse. For more on that rule, and the ability of a nonspouse Designated Beneficiary to transfer inherited nonIRA plan benefits via direct rollover to an "inherited" IRA, see ¶ 4.2.04 of *Life and Death Planning for Retirement Benefits*. For the ability of the surviving spouse to roll over benefits paid to her, see ¶ 3.2.

B. **Required minimum distributions.** A required minimum distribution (RMD) cannot be rolled over. See ❦1.1.

C. **Series payments.** "[A]ny distribution which is one of a series of substantially equal periodic payments" made annually or more often (1) over the life or life expectancy of the participant, (2) over the joint life or life expectancy of the participant and a designated beneficiary, or (3) over a "specified period of 10 years or more" may not be rolled over. § 402(c)(4)(A). Reg. § 1.402(c)-2, A-5, explains how to determine whether a distribution is part of a series of substantially equal payments.

D. **Corrective and deemed distributions.** Certain corrective or "deemed" distributions from a qualified retirement plan (QRP) cannot be rolled over. See list at Reg. § 1.402(c)-2, A-4(d), (f). Thus a deemed distribution from a qualified plan is generally a "chute" that has no "ladder." Does the same prohibition apply to "deemed" distributions from an IRA? There is no IRS pronouncement on that point.

E. **Hardship distributions.** Hardship distributions from nonIRA plans cannot be rolled over. § 402(c)(4)(C). (IRAs don't make hardship distributions so this question does not arise.)

F. **Once-in-12-months limit on IRA-to-IRA rollovers.** See ❦1.7 for a limit on the number of IRA distributions that may be rolled to an IRA within 12 months.

G. **Plan loans.** A plan loan that is deemed distributed under § 72(p) (because the loan does not conform with the plan-loan rules) is not an eligible rollover distribution. See ❦2.4.

H. **After-tax money.** Both pre- and after-tax money may be rolled over from a QRP to a traditional IRA. § 402(c). (Reg. § 1.402(c)-2, A-3(b)(3), which provides to the contrary, has not been amended to reflect this 2001 law change.) However, after-tax money may *not* be rolled in the other direction (from an IRA to a QRP): § 408(d)(3)(A)(ii) generally allows rollovers from any traditional IRA to any other type of plan in years after 2001, but if the

rollover is made from an IRA into a QRP, a 403(a), 403(b), or 457 plan, only the *pretax* money in the traditional IRA may be rolled. § 402(c)(8)(B)(iii), (iv), (v), (vi).

❦3.5 Hardship Waiver of the 60-day Rollover Deadline

There is generally a 60-day deadline for completing a rollover; see ❦1.5 for details and exceptions.

The IRS "may waive the 60-day requirement…where the failure to waive such requirement would be against equity or good conscience, including casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement." § 402(c)(3)(B); § 408(d)(3)(I) (effective for distributions after 2001).

A. Procedure to request a waiver

In Rev. Proc. 2003-16, 2003-1 C.B. 359, the IRS issued the following guidance for such hardship waivers. A participant or surviving spouse can request a hardship waiver of the rollover deadline by following the usual procedures for obtaining a private letter ruling.

Although the legislative history of EGTRRA indicates that Congress wanted the IRS to issue "objective standards" for granting hardship waivers of the 60-day deadline, the Rev. Proc. says only that the IRS will consider "all relevant facts and circumstances," such as "death, disability, hospitalization, incarceration, restrictions imposed by a foreign country or postal error;...the use of the amount distributed (for example...whether the check was cashed); and...the time elapsed since the distribution occurred."

Obtaining an IRS letter ruling requires payment of a "user fee" (filing fee). Under Rev. Proc. 2012-8, 2012-1 IRB 235, § 6.01(4), requests for hardship waivers of the 60-day rollover deadline have their own user fee schedule, which is: If the rollover is less than $50,000: $500; if the rollover is $50,000 or more, but less than $100,000: $1,500; and if the rollover is $100,000 or more: $3,000.

B. Earnings and RMDs during the out-of-plan gap period

Getting a hardship waiver does not solve all the problems. For example, see the problem of designating a beneficiary for an IRA established by the participant's executor to receive a late rollover of a distribution made during the participant's life, discussed at ¶ 4.1.04(B) of *Life and Death Planning for Retirement Benefits*.

Also, all that can be rolled over is the amount of the distribution, not any income earned on that distribution during the period of time the money was outside the IRA—regardless of how long that was, and regardless of what hardship prevented the participant from completing the rollover on a timely basis. Rev. Proc. 2003-16, § 3.04.

Another problem with long-delayed rollovers is what to do about required minimum distributions (RMDs) that would otherwise have accrued in the meantime. The waiver rulings typically specify that interim RMDs cannot be rolled over despite the extension but do not specify how that nonrollable amount is to be determined.

Polly Example: Polly suffered from a mental disability in 2007, when she was age 69, and she cashed out her entire $500,000 IRA. She did not have the mental capacity to know what she was doing. In 2008, the year she reached age 70½, she was placed under guardianship due to her mental disability, and the guardian discovered the 2007 distribution. The guardian on Polly's behalf applied for a waiver of the 60-day deadline to allow the $500,000 distribution to be recontributed to the IRA. The waiver is granted by the IRS in 2009, subject to the condition that any RMD cannot be rolled over. But there was no RMD for the year that the distribution came out of the IRA, in 2007, because Polly was only 69 years old. An RMD *would have accrued* in 2008 and 2009 if the money had still been in the IRA, but there was no "prior year-end balance" for either year because the account didn't exist. Accordingly it would appear that the guardian can roll over the entire $500,000 in 2009 and start taking RMDs in 2010. This does not "cheat" the IRS too much because Polly was taxable in 2008 and 2009 on the income earned by the $500,000 distribution outside the IRA (and she is not allowed to roll over that income "as if" it had been earned inside an IRA). There is no IRS guidance either confirming or denying the above conclusions.

C. Typical grounds for granting waiver: Advisor error, illness, etc.

Following issuance of Rev. Proc. 2003-16, the IRS began issuing a flood of private letter rulings dealing with these deadline waiver requests. Most successful waiver requests involve one or more of the following situations:

Error by a financial advisor or institution is by far the most common reason for obtaining a deadline waiver, accounting for at least half of all rulings in the author's estimate. The "good" news is that the IRS *almost* always grants the waiver when the participant missed the deadline due to a processing error by an financial institution or advisor. Generally the IRS seems to require the financial institution or advisor to admit the mistake in writing. Typical are rulings in which the participant's new financial advisor or institution inadvertently established a regular taxable account instead of an IRA with funds transferred from prior advisor or institution, such as PLRs 2004-02028, 2004-04053, 2004-01023, 2004-20035, 2009-51040, 2010-14073. If the professional error involved erroneous tax advice rather than a straight processing error, the standards are tougher: If the advisor gave erroneous advice *about the rollover requirements* (such as telling the participant that the deadline is 90 days not 60 days), the IRS will generally grant the waiver; but regarding other erroneous tax advice, see "E" below.

Distribution not requested. In many successful waiver requests, the original distribution was "involuntary," in that the participant hadn't requested it and often did not even realize it had occurred (*e.g.*, it was mailed to an outdated address), or the participant was mentally incompetent to understand the consequences of withdrawing the funds. See PLRs 2004-21009, 2004-21008, 2004-27027, 2004-35017, 2004-36014, 2010-15040, 2010-16093.

Health problems, trauma: Many successful waiver requests involved participants who were hampered from initiating and/or completing the rollover by significant mental or physical health problems (of themselves or close family members), a death in the immediate family, or other

catastrophes. See PLRs 2004-30039, 2004-30040, 2004-36021, 2004-04051, 2004-12002, 2004-26020, 2004-30037, 2004-30038, 2004-36021, 2009-36048, 2010-15042, 2010-05059.

The waiver can be granted long after the original distribution. See PLRs 2003-27064 (rollover allowed more than a year after funds were stolen from IRA; loss had not been discovered immediately) and 2007-05031 (rollover allowed in 2005 of a "restorative payment" replacing losses incurred due to defalcations by the advisor in the years 2000–2004).

D. Typical grounds for denying waiver: Participant spent funds, etc.

The IRS is most likely to refuse a waiver when the taxpayer deliberately took the distribution (e.g., to qualify for Medicaid, PLR 2005-47024, or to pay medical expenses, PLR 2005-49023, or to complete a house closing, PLR 2005-44025); and/or showed no evidence of intent to roll it over until after the 60-day deadline (typically, when he discovers it is taxable; PLR 2005-46047, 2005-48030, 2005-49017, 2004-33029, 2004-22058); or he deliberately took it, intending to spend it and then replace the funds with other funds, but he did not receive the replacement funds in time to meet the 60-day deadline (PLRs 2004-17033, 2004-22053, 2004-23038, 2004-33022, 2004-36018, 2005-44025).

However, even if the participant did deliberately use his IRA as a "source of short-term financing," the IRS will grant the waiver if the participant had the replacement funds, and sent them in to the IRA provider, within the 60-day time limit, if the deadline was then missed due to financial institution error or other cause beyond the participant's control. See, *e.g.,* PLR 2010-16092.

E. Evolving and inconsistent IRS standards

The IRS has grown more restrictive over the years when it comes to granting hardship waivers. In the early days some waiver requests were granted where the taxpayer really didn't have much of an excuse. More recently, the IRS has denied waivers for such "flimsy" excuses as: participant was busy getting ready to go on vacation (2007-30024); minor surgery (2007-51032); participant's father's cancer and death (2008-29030); participant's sibling's financial crisis (2010-02049); and participant's lack of a college education and lack of knowledge of legal, accounting, or tax matters (2010-03030).

The IRS has taken to reciting the following mantra in the PLRs where it denies the waiver: A waiver will be granted *only* if the deadline was missed because of one of the factors listed in Rev. Proc. 2003-16. See, *e.g.*, PLRs 2007-27023, 2007-30023, 2010-15039. Yet this pious recital is absent in many PLRs which *do* grant a waiver, because the IRS regularly grants waivers when the ability to meet the rollover deadline was completely within the participant's control at all times and no factor listed in the Rev. Proc. existed; see, *e.g.*, PLRs 2004-11052, 2006-06055, 2009-30052, 2009-51044, and 2009-52066 (waiver granted because the final day of the 60-day period fell on a bank holiday); PLRs 2007-15016 (participant received two distributions when he had requested one; he was granted a waiver despite no mention of any illness or other problem that prevented him from noticing the double distribution or rolling it over); and 2007-08085, 2007-26031.

Another inconsistency has to do with reliance on tax advice of a professional advisor. Sometimes erroneous tax advice is grounds for granting a waiver…and sometimes it isn't. In PLR 2006-17039, the IRS *refused* a waiver where a participant took a distribution of employer stock from his company plan, not intending to roll it over because his advisor told him the distribution qualified for a special tax treatment. After the 60-day rollover deadline had passed, he found out the distribution did *not* qualify for that treatment. Says the IRS "We do not believe that Congress intended to permit the Service to retroactively correct tax treatment choices which do not produce the expected benefits even though…these choices were the result of erroneous advice" by the financial consultant. But in PLRs 2006-09019 and 2009-25047 the IRS *granted* waivers to widows who were told (incorrectly) by their advisors that distributions from their deceased husband's retirement plans were tax-free. What's the difference? The IRS mentions the widow's depression in PLR 2009-25047; is the IRS saying that it is reasonable to rely on professional tax advice only if you are mentally ill?

The most insidious trend in IRS waivers is that they will not grant the waiver if the *taxpayer himself* made a mistake that caused the rollover deadline to be missed (and the taxpayer was not incapacitated). For example, an individual who clearly requested a direct rollover to an IRA, but wrote the wrong account number on his form, so the money went into a taxable account by mistake, and nobody noticed the mistake until after the deadline had passed—the IRS did not grant a waiver, because they said the ability to complete the rollover was within his control at all times. See PLRs 2010-02049, 2010-03030, 2010-06035, 2010-07080, 2010-15039, and 2010-37038 for other examples of this trend.

The tragedy is that, in most of these hardship waiver-seeking cases, if the participant had just read his account statements when they came in, he would have discovered the mistake immediately and been able to fix it within 60 days.

❦3.6 Recharacterization of an IRA Contribution

This section is an abbreviated version of ¶ 5.6 of *Life and Death Planning for Retirement Benefits*, "Recharacterizing an IRA or Roth IRA Contribution."

The law provides broad relief to a taxpayer who wishes to "adjust" an IRA contribution by switching the contribution from a Roth IRA to a traditional IRA or vice versa. § 408A(d)(6). The IRS calls this relief "recharacterizing" an IRA contribution. It is available to anyone who changes his mind about which type of IRA he wants his "regular" contribution to go to, or about a Roth conversion he has done, as well as to someone who needs to correct a Roth conversion or contribution for which he was ineligible. Reg. § 1.408A-5, A-10, Example 2. Since recharacterization applies only to *IRA contributions*, it is not available for "in-plan conversions" (see ¶ 5.7.11 of *Life and Death Planning for Retirement Benefits* regarding "in-plan conversions").

An IRA contribution is "recharacterized" by transferring the original contribution, plus any earnings that the contribution has earned while inside the plan, from the IRA that received the contribution to an IRA of the other type (traditional or Roth).§ 408A(d)(6)(B); Reg. § 1.408A-5, A-2(a). For how to compute the earnings on a recharacterized contribution, see ❦4.2.

5.6.01 ***Which IRA contributions may be recharacterized***

Not all IRA contributions can be recharacterized. Here are IRA contributions that can be recharacterized; see ❦4.3 regarding the difference between "regular" and "rollover" contributions.

✓ The only type of "rollover contribution" that can be recharacterized is a Roth conversion, i.e. a rollover from a traditional plan or IRA into a Roth IRA. The contribution (conversion) to a Roth IRA of a distribution from a traditional plan or IRA may be recharacterized as a contribution to a traditional IRA. Both valid Roth conversions and "failed" conversions (see ❦2.1) may be recharacterized. Reg. § 1.408-8, A-8(b).

✓ A "regular contribution" to an IRA or Roth IRA can be rerouted into the other type of IRA (if the contributor was eligible to contribute the amount to the *other* type of IRA) by recharacterization. § 408A(D)(6); Reg. § 1.408A-5, A-3; A-10, Example 2.

Here are IRA contributions that can NOT be recharacterized:

❑ If money has been rolled over from a *traditional* retirement plan into a *traditional* IRA via a tax-free rollover (whether by direct rollover or 60-day rollover; see ❦4.4 for the difference), the taxpayer cannot later change his mind and "recharacterize" that as a Roth conversion by moving the rolled amount to a Roth IRA. "[A]n amount contributed to an IRA in a tax-free transfer cannot be recharacterized." Reg. § 1.408A-5, A-4, A-10, Example 4. The individual *can* convert to a Roth IRA the traditional IRA he has created via this rollover; he just cannot make such conversion "retroactive" to the original rollover.

❑ Similarly, employer contributions to a SEP or SIMPLE IRA may not be recharacterized as contributions to a Roth IRA, because the employer could not have made direct contributions to a Roth IRA in the first place. Reg. § 1.408A-5, A-5. But, once the employer has made its contribution to the SEP or SIMPLE, the employee can convert the SEP or SIMPLE account to a Roth IRA; see ¶ 5.4.01(A) of *Life and Death Planning for Retirement Benefits*.

❑ If a nonspouse Designated Beneficiary mistakenly rolls inherited nonIRA plan benefits into the beneficiary's *own* Roth IRA (rather than via direct rollover into an inherited Roth IRA; see ¶ 4.2.04(E), ¶ 4.2.05, of *Life and Death Planning for Retirement Benefits*), the invalid rollover is treated as a distribution followed by a *regular contribution* to the beneficiary's own Roth IRA. Reg. § 1.408A-8, A-1(B)(4); § 1.408A-4, A-1(a), A-3(b). Recharacterization cannot cure the problem because the beneficiary is not entitled to roll the distribution into his own traditional IRA either.

❑ From IRS Publication 590 (*IRAs*), 2013, p. 30: "You can recharacterize only actual contributions. If you are applying excess contributions for prior years as current contributions, you can recharacterize them only if the recharacterization would still be timely with respect to the tax year for which the applied contributions were actually made."

5.6.03 How to recharacterize certain IRA/Roth IRA contributions

A recharacterization is effected by transferring the contribution that is to be recharacterized (plus earnings attributable thereto) to the other type of IRA by a certain deadline. § 408A(d)(6), (7). A recharacterized contribution will be treated for income tax purposes as having been contributed to the transferee IRA (rather than the transferor IRA) "on the same date and (in the case of a regular contribution) for the same taxable year that the contribution was made to the" transferor IRA. Reg. § 1.408A-5, A-3. Although the Code makes it appear that *any* transfer of the IRA contribution amount to the other type of IRA before the applicable deadline is automatically treated as a recharacterization, the Regulation is clear that the treatment is elective. Reg. § 1.408A-5, A-1(a), (b), A-6.

For which contributions may NOT be recharacterized, see ¶ 5.6.01 above. For partial recharacterizations, see ¶ 5.6.04 below. For the deadline applicable to recharacterizations, see ❦4.1. See ¶ 1.2.07 of *Life and Death Planning for Retirement Benefits* regarding the effect of a recharacterization on calculation of the required minimum distribution.

Here are the requirements for effecting a recharacterization:

1. Recharacterization is accomplished by moving the recharacterized traditional or Roth IRA contribution to the other type of IRA (Roth or traditional) by direct trustee-to-trustee transfer following the required notifications (see #3). A "60-day rollover" may *not* be used. Reg. § 1.408A-5, A-1(a). See ❦4.4 for the difference.

2. Not only the original contribution but "any net income attributable to such contribution" must be transferred. Reg. § 1.408A-5, A-2(a). See ❦4.2 for how to compute the "income attributable."

3. The election to recharacterize is made by providing notice and directions to the IRA sponsors involved, *on or before the date of the transfer*, to carry out the transfer of funds or property directly from the transferring IRA into the transferee IRA. Reg. § 1.408A-5, A-6(a).

4. The election to recharacterize "cannot be revoked" after the transfer to the other type of IRA has occurred. Reg. § 1.408A-5, A-6(b).

5. A recharacterization is "never treated as a rollover for purposes of the one-rollover-per-year limitation…, even if the contribution would have been treated as a rollover contribution by the…[transferee] IRA if it had been made directly to the" transferee IRA in the first place. Reg. § 1.408A-5, A-8. See ❦1.7 regarding the one-rollover-per-12-months limitation.

6. A Roth conversion that comes from a *nonIRA* plan is recharacterized by moving the converted amount (and earnings) out of the Roth IRA and *into a traditional IRA*, NOT back into the traditional nonIRA plan it was in prior to the Roth conversion. See Notice 2008-30, 2008-12 IRB 638, A-5, A-7.

5.6.04 Partial recharacterizations

Partial recharacterizations are permitted. Reg. § 1.408A-5, A-1(a).

However, you cannot "cherry pick" the assets you recharacterize so as to recharacterize only the "losers." If a participant converted his IRA to a Roth IRA at a time when the account contained 100 shares of Acme and 100 shares of Omega, and then a few months later the Acme had appreciated but the Omega had declined in value, the participant might like to recharacterize just the Omega stock. But the regulation's definition of the "income" on the account (the income that must be transferred to a traditional IRA along with the contribution being recharacterized; see ❦4.2) is based on the appreciation and depreciation *of the entire account*, not of the particular assets you might choose to recharacterize. Reg. § 1.408A-5, A-2(c)(5), (c)(6), Example 2.

If an individual converts his IRA to *multiple* Roth IRAs, the regulations permit him to "unconvert" one or more of the multiple Roths without undoing all of them. See Reg. § 1.408A-5, A-2(b), (c)(4). Thus, a client might consider converting his IRA into several Roth IRAs, with portfolio assets whose values are less likely to move in tandem placed into separate Roth IRAs. That way, if one asset class declines in value prior to the deadline for recharacterizing the account, he can recharacterize just the Roth IRA that holds that asset class, and leave the other Roth IRAs alone. If using this strategy, the assets can be moved from a single traditional IRA directly into the multiple destination Roth IRAs; it is not necessary to first divide the assets into multiple traditional IRAs then convert those.

Note to advisors recommending this strategy: This strategy has the drawback of complexity, and also, though it does work as of this writing, the IRS and/or Congress may be unhappy about this type of tax gaming, and may eliminate the availability of this strategy.

5.6.07 Same-year and immediate reconversions banned

Once a recharacterization of an amount converted from a traditional IRA to a Roth IRA occurs, the individual "may not reconvert that amount" to a Roth IRA until the taxable year following the taxable year of the original conversion, or until at least 30 days have elapsed since the recharacterization, *whichever is later*. Thus, recharacterization cannot be used to flip back and forth quickly between traditional and Roth IRA status. If the individual attempts to reconvert before the prescribed time period ends, the result is a *failed conversion*. Reg. § 1.408A-5, A-9. See ❦2.1.

A Roth conversion that was effected by transfer to a Roth IRA from a nonIRA plan can be recharacterized under § 408A(d)(6). Notice 2008-30, 2008-12 IRB 638, A-5. The rule banning same-year reconversions, by its explicit terms, applies only with respect to recharacterized conversions from *an IRA* to a Roth IRA, not to conversions from a nonIRA plan. It's not clear whether the ban also applies to plan-to-Roth-IRA conversions; although there is a rule that plan-to-Roth-IRA conversions are includible in income "as if" the money went through a traditional IRA first on its way to the Roth IRA (see Notice 2009-75, discussed at ❦2.1), there's no general rule that all rules applicable to one type of conversion automatically apply to the other.

❦3.7 Missing the Recharacterization Deadline: 9100 Relief

For the taxpayer who misses the deadline for recharacterizing, there is still hope. First, Congress and the IRS sometimes grant blanket extensions of time and other relief to the victims of particular disasters. If the taxpayer is affected by such a disaster he may be entitled to complete a Roth recharacterization later than other taxpayers.

For everybody else, there are procedures for applying to the IRS for relief in cases of good faith errors. § 301.9100-1(c) of the IRS's "Procedure and Administration Regulations" provides that the IRS may grant a "reasonable extension of the time fixed by a regulation" or other IRS decree "for the making of an election or application for relief in respect of tax…."

In dozens of private letter rulings, the IRS has been generous in using these relief provisions to grant extensions of time for recharacterizations of erroneous Roth conversions in deserving situations. The IRS allows late recharacterization of a Roth conversion, typically, when the taxpayer who did the conversion wasn't even eligible to do a Roth conversion but was mis-advised by his professional advisors who told him he *could* do a Roth conversion, and who was again failed by his advisors who didn't tell him about their error in time to allow him to do a timely recharacterization. This section ❦3.7 looks at the rules for obtaining 9100 relief especially as they apply to late recharacterizations.

Applying for 9100 relief

There are certain extensions of time that are automatic; see Reg. § 301.9100-2. This is the regulation that allows the "automatic" six months' extension of time from April 15th to make an election to recharacterize a Roth conversion. See ❦4.1 below.

Once you get beyond the time of the automatic extension, you need to apply to the IRS for individual permission to make a late election. Applying for 9100 relief on a Roth recharacterization gets it own special reduced "user fee" of $4,000. Rev. Proc. 2012-8, 2012-1 IRB 235, § 6.01(9).

Reg. § 301.9100-3 sets the following standards that must be met in order for the IRS to grant an extension of time beyond the automatic extensions covered by § 301.9100-2. The IRS will grant relief when the taxpayer applying for the relief provides sufficient evidence (including specified affidavits) "to establish that (1) the taxpayer acted reasonably and in good faith, and (2) granting relief would not prejudice the interests of the Government." The regulations then elaborate on the meaning of these two phrases.

Reasonably and in good faith

Under Reg. § 301.9100-3(b)(1), the taxpayer is deemed to have acted reasonably and in good faith if:

(i) the request for "9100 relief" is filed before the failure to make a timely election is discovered by the Service;

(ii) the taxpayer's failure to make the election was due to intervening events beyond the taxpayer's control;

(iii) the taxpayer failed to make the election because after exercising reasonable diligence, the taxpayer was unaware of the necessity for the election;

(iv) the taxpayer reasonably relied upon the written advice of the Service; or

(v) the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make, or advise the taxpayer to make, the election. See the regulation for detail on what constitutes "reasonable reliance" on a "qualified tax professional."

Note: In the above list of five items, it might appear that the list should read that the taxpayer must meet the test in (i) (i.e., he filed for relief before the IRS discovered the error), *plus* one of the other four tests (i.e., the reasons he failed to file the election on time). However, the regulation lists all five items with the "or" connector, indicating that applying for the relief before the IRS discovers the error is sufficient to establish good faith, provided none of the badges of "not such good faith" (see next paragraph) is present. See Reg. § 301.9100-3(f), Example 1.

See Reg. § 301.9100-3(b)(3) for detail on what facts indicate the taxpayer is *not* acting reasonably and in good faith. For example, if the taxpayer was "informed in all material respects of the required election and related tax consequences, but chose not to file the election" he does not get relief. You can't simply change your mind and expect to get relief.

Similarly, if the "facts have changed" since the election deadline in such a way as to cause the unmade election to appear more favorable than it appeared at the time when taxpayer chose not to make the election, the IRS will not permit the taxpayer to make a late election unless "the taxpayer provides strong proof that …the decision to seek relief did not involve hindsight." Thus, for example, the Service will not grant a late recharacterization of a Roth conversion merely because the taxpayer's investment values declined after the conversion (and after the recharacterization election deadline) so he wishes he hadn't done it. See PLR 2010-24071.

Prejudicing the interests of the government

The IRS looks at two factors to determine whether the government's interest is prejudiced by allowing a late election.

The first is whether allowing the taxpayer to make a late election would result in a lower tax liability in the aggregate for the years affected, either for that individual taxpayer or for a group of taxpayers. Reg. § 301.9100-3(c)(1)(i).

The other is whether the year in question is "closed," i.e., the statute of limitations has expired on the ability of the IRS to collect taxes for that year. "Ordinarily" the government's interest is prejudiced if the taxable year of (or years affected by) the election is (or are) closed.

What the IRS is looking at here is whether the tax liability would be the same, if a late election is permitted, as it would have been if the election had been timely filed. Thus, a late Roth recharacterization may be permitted even if it results in substantially reducing the taxpayer's income tax liability for a closed year. This was the case in PLR 2012-27008, in which Taxpayer A converted funds from his traditional IRA to a Roth IRA over two years, 2008 and 2009. Unbeknownst to him, he was not eligible to do these conversions because his income in those years exceeded $100,000 (this income limit applied to Roth conversions prior to 2010). This fact was not discovered until a couple of years later, when it was realized that this taxpayer's reported income for 2008 and 2009 should have included certain foreign dividend income. By the time all this was sorted out, the deadline for recharacterizing 2008 and 2009 conversions had long since passed and 2008 was a closed year.

The taxpayer sought 9100 relief—permission to do a late recharacterization. Good faith error was established. Now how about prejudicing the interest of the government? You might think the government's interest is prejudiced because it would have to pay back the income taxes "A" paid on his Roth conversions. But the IRS did not compare the tax effects of allowing the late election vs. not allowing it. The IRS compared only the tax effects of a late recharacterization election and the tax effects of a timely recharacterization election. Viewed that way there was no difference, so the IRS found the interest of the government were not harmed by allowing this late election and granted the extension for both of the years.

Typical use of 9100 to make a late Roth recharacterization

In dozens of private letter rulings, the IRS has been generous in using these relief provisions to grant extensions for recharacterizations of erroneous Roth conversions in deserving situations. See, *e.g.*, PLRs 2001-16053 (taxpayer erroneously believed that due date of her return was October 15 and that capital gain did not count toward the then-applicable $100,000 Roth conversion income limit); 2001-16057 (recharacterization of improper Roth conversion was late due to financial institution error); 2001-16058, 2001-19059, 2001-20040, 2001-22050, 2001-28058, and 2001-30058 (taxpayers unaware they didn't qualify for Roth conversion and unaware of recharacterization deadline); 2001-26040 (taxpayers had been erroneously advised that the Roth IRA conversion income limit then applicable was $150,000, that the deadline for a 1998 conversion was 4/15/99, etc.); and 2001-29040 (taxpayer ineligible to convert, and thought she had timely recharacterized all her Roth IRAs, but missed the deadline on one of them because she forgot about that account). For additional examples, see PLRs 2008-50052, 2008-26040, 2009-09073, 2009-21036, 2009-28044, 2009-48065, 2010-04037, and 2010-16095.

❦3.8 Getting out from under the Penalty for Missed RMD

Once it is determined that the 50 percent penalty imposed by § 4974(a) is owed for missing an RMD (see ❦2.6), there are only three paths that may enable you to escape it.

A. Nonspouse beneficiary complies with 5-year rule.

If a participant dies before his required beginning date (RBD), leaving benefits to one individual nonspouse beneficiary, that beneficiary is supposed to take RMDs, beginning in the year following the year of the participant's death, in annual instalments over the beneficiary's life expectancy. If the beneficiary fails to take one or more of such payments in the first five years after the participant's death, he can avert the penalty by withdrawing the entire plan balance by December 31 of the year that contains the fifth anniversary of the participant's death. Reg. § 54.4974-2, A-7(b).

B. Deemed election by spouse beneficiary to treat inherited IRA as spouse's own

Unlike other beneficiaries, a surviving spouse who is the sole beneficiary of a deceased participant's IRA has the option to elect to treat this inherited IRA as if it were the surviving spouse's own IRA. One effect of the election is that the surviving spouse's RMDs from the IRA will be computed based on her being the owner of the IRA, rather than being a beneficiary of the IRA. Reg. § 1.408-8, A-5(a). (See ¶ 3.2.03 of *Life and Death Planning for Retirement Benefits* for complete explanation of this option.)

One way for the surviving spouse to make the election is for the surviving spouse to fail to take, by the applicable deadline, "any amount" that is required to be distributed to her as a beneficiary under the minimum distribution rules. Reg. § 1.408-8, A-5(b)(1). Note that even a $1 shortfall in the RMD would apparently trigger this deemed election (under the "any amount" standard). This deemed election can serve as a magic cure to eliminate a penalty, because (except in the actual year of death itself), the election is effective retroactively to the beginning of the year. Reg. § 1.408-8, A-5(a), fourth sentence.

Tyrone Example: Tyrone's wife died in 2009, at age 72, leaving her IRA to Tyrone as sole beneficiary. Tyrone (age 68) should have started taking RMDs in 2010, the year after his wife's death, in annual instalments over Tyrone's life expectancy; see ¶ 1.6.03 of *Life and Death Planning for Retirement Benefits*. However, he was so grief stricken he did nothing. He took no distributions from the account in 2010. Now he meets with you, in 2011. Does he owe a penalty for failure to take that 2010 RMD? No. Because of Reg. § 1.408-8, A-5(b)(1), Tyrone, by failing to take the RMD for 2010 in the year 2010, was deemed to have made an election to treat the IRA as his own IRA. The deemed election was retroactive to the beginning of 2010. If the IRA is treated as Tyrone's own IRA for the year 2010, then he did not have to take any RMD in 2010, because he has not yet reached age 70½.

C. Request waiver of the penalty: Road Map

The more often used way to negate the penalty is to request a penalty waiver from the IRS. The penalty can be waived by the IRS on a case-by-case basis (§ 4974(d)) "if the payee described in section 4974(a) establishes to the satisfaction of the Commissioner" that "(1) The shortfall...in the amount distributed in any taxable year was due to reasonable error; and (2) Reasonable steps are

being taken to remedy the shortfall." Reg. § 54.4974-2, A-7(a). The request for a waiver is submitted with Form 5329; see IRS Publication 590 (*IRAs*), 2013, p. 59.

The "payee" does *not* have to pay the penalty as a condition of requesting the waiver; that condition, which appeared in pre-2005 editions of the IRS instructions, no longer appears anywhere.

There are no published rulings or other IRS pronouncements regarding the standards used in determining whether there was "reasonable error." Presumably the requirement that reasonable steps be taken to remedy the shortfall means that the taxpayer must take the distributions that were missed in prior years before requesting the waiver.

Here is the ROADMAP for requesting a waiver to the penalty:

1. File one form 5329 for each year in which the client missed taking an RMD. For example, if it is now 2014, and the client failed to take his RMD in the years 2011 and 2012, you will file one form 5329 for 2011 and one for 2012. If the client has not yet filed his income tax return for the applicable year (Form 1040, or 1041 in the case of a trust or estate), the Form 5329 can be attached to the income tax return when filed. If the Form 1040 (or 1041) has already been filed for the applicable year, file Form 5329 as a stand-alone return.

2. You do NOT file an amended income tax return for the applicable year. There is nothing to "amend" by way of your reported income and deductions; the distribution will be taken NOW, so it will be reportable in the current year, not the year you didn't take it.

3. "Remedy the shortfall": Have the client withdraw from the IRA, now, the amount of the missed RMD. Though not legally required, I would recommend that the client take a separate withdrawal check for each year that he missed an RMD, that the check NOT be combined with any other distribution, and that the client NOT have any taxes withheld from his "shortfall" check. That way, the client will have a nice clean check for the exact amount of the missed distribution; make a copy of that check to attach to the Form 5329, then deposit the check in the client's taxable bank account.

3. Complete Part VIII of the Form 5329 ("Additional Tax on Excess Accumulation in Qualified Retirement Plans (Including IRAs)") as follows.

    (A) On line 50, enter the amount of the required minimum distributions the client was SUPPOSED to take.

    (B) On line 51, enter the total of distributions the client actually DID take during the applicable year.

    (C) On line 52, enter "zero," and write "RC" in the margin. Do NOT enter the amount of the shortfall! Even though it APPEARS that you should enter on this line the amount the client failed to take, you are supposed to put ZERO on this line if you are requesting a waiver of the penalty! If you put any dollar amount on this line, you are a dead man: The IRS will assess the penalty and start sending you dunning notices.

(D) On line 53 (amount of penalty), enter zero.

4. Attach a statement to the Form 5329 indicating the client's reasonable cause and also verifying that the client has "remedied the shortfall" (attach a photocopy of the "shortfall check").

5. File the package with a cover letter listing what is being filed.

....If you follow this Road Map, and the IRS accepts your "reasonable cause," you should receive notice from the IRS in a few months, indicating they are accepting the return as filed. (If the 5329 is attached to an income tax return, then you will not receive a notification regarding the return being accepted.) If they don't buy your reasonable cause, you'll get a bill!

D. Request waiver of the penalty: Example

John is your new client. He is age 85. His accountant died two years ago, leaving John's tax records in disarray. John moved, and the IRA provider (though notified of his new address) continued to send all notices etc. to his old address so John did not receive any reminders about taking his RMD in the last two years prior to the current year. His wife was severely ill and he was her sole caretaker until her death earlier this year. Due to his severe stress caused by his wife's situation, and due to the loss of his accountant and the paperwork errors by the IRA provider, John failed to take his RMDs for last year and the year before. Now he sees you. He has not yet filed his return for last year; it is on extension. His RMD for the year before last would have been $15,000. He actually withdrew only $2,000. Last year, he withdrew nothing, but should have withdrawn $18,000.

You prepare Form 5329 for last year and the year before. You have John obtain three separate checks from the IRA provider, now. One is for $13,000 (the shortfall for the year before last), one is for $18,000 (the shortfall for last year), and one is for $21,000 (the amount of John's RMD for this year). John instructs the IRA provider NOT to withhold any income tax from the two shortfall checks (he can have taxes withheld from this year's check if desired).

Note: It is not a legal requirement that you get a separate check for each year's "shortfall" amount, or that you not have taxes withheld from a shortfall check. It's just a *recommended* idea for the purpose of making it as easy as possible for the IRS agent reviewing your Form 5329 to see that you did in fact "remedy the shortfall!"

On the form 5329 for the year before last, you enter "$15,000" on line 50, "$2,000" on line 51, and "zero" on lines 52 and 53. You write "RC" in the margin. You prepare a statement to attach, explaining the reasonable cause and how the shortfall was remedied. John signs the Form 5329 and you file it as a standalone return with a cover letter listing the return (Form 5329), the reasonable cause statement, and the attached photocopy of the shortfall check. Hopefully you receive notice in a few months that the return is accepted as filed.

On the form 5329 for last year, you enter "$18,000" on line 50, "zero" on line 51, and "zero" on lines 52 and 53. You write "RC" in the margin. You prepare a statement to attach, explaining the reasonable cause and how the shortfall was remedied. John signs the Form 5329 and you attach it

to his Form 1040 for last year (which will be timely filed by the extended due date), along with a copy of the "reasonable cause" statement and the shortfall check.

❦3.9 Undistributing: The Law of the 1099-R

Retirement plans and IRA providers are required to report to the IRS all distributions that are made from the account, on Form 1099-R. Once a plan or IRA has issued a Form 1099-R, the participant (or beneficiary) will have to report that distribution on his federal income tax return (Form 1040). The recipient may be able to correctly report the distribution as nontaxable (for example, if it was rolled over to another plan on a timely basis, or if it is a "qualified charitable distribution," or if it is a qualified distribution from a Roth IRA). But once the 1099-R is issued, the recipient will have the burden of either paying tax on the distribution, convincing the IRS that it is nontaxable, or getting the plan to issue a corrected form or otherwise void the 1099-R.

Thus, planners often have to be involved in determining that the client receives the correct 1099-R and receives a 1099-R only when it is appropriately required.

So if a 1099-R must be issued when there is a distribution from the plan, the next question is, when does a "distribution" from a plan or IRA occur? When the plan makes a charge against the participant's account on its books? When it cuts the check, signs the check, mails the check? When the participant or beneficiary receives the check, endorses the check, delivers the check to the bank? When the check clears?

The Code and regulations make it sound as though a distribution is a clearly defined physical event: Money has either been distributed *out* of the plan or it is still *in* the plan. Once it's out it is out, and it cannot be "undistributed."

In the real world the subject is more nuanced. For example, many distributions are carried out by means of electronic book entries, not by delivery of a physical check, and electronic entries can be reversed by other electronic entries. Even once a check has been mailed, has money been "distributed" if the check is returned to the plan administrator before it is endorsed or cashed, and the plan administrator destroys or stops payment on the check?

There are situations when mistakes can be undone by reversing book entries (or returning checks uncashed). The key thing is to get the mistake "erased" from the plan administrator's books before the transaction has hardened into something that will be reported to the IRS on Form 1099-R, and ideally before it appears on any monthly printed statement.

Chickie Example: Chickie inherits her mother's traditional 401(k) plan (as sole designated beneficiary of the plan account) and requests a direct rollover of half the account into an "inherited Roth IRA" and half into an "inherited traditional IRA," both of which she has opened at XYZ Bank. Chickie has signed all the right paperwork, but while viewing the transaction online she discovers that the XYZ Bank placed all of the money into the inherited traditional IRA and none into the inherited Roth IRA. She calls the bank and explains the error and points out that this error was caused by bank negligence (her instructions were clear and all the paperwork was in order) and the bank will be liable for any consequences. The bank manages to reverse the book entries that had been made and replace them with other book entries that correctly carry out Chickie's instructions.

❦3.10 Sue somebody!

This ladder is empty. In view of the number of mistakes that get made in handling retirement benefits, from incorrect tax advice, to improperly drafted beneficiary designations, to rollover mixups by financial institutions, one would think that there would be many cases on record by now where retirement plan participants or beneficiaries recovered damages from the lawyer, accountant, financial planner, bank, mutual fund, or brokerage firm that mis-handled their retirement benefits. In fact there is no such case of record, at least none that has come to the attention of this author.

Thus, there is no case (for example) establishing the measure of damages where a beneficiary "loses out" on the "stretch" life expectancy payout of his inherited benefits (receiving instead an immediately taxable lump sum) due to an error made by a planner or financial institution. Perhaps no lawyer wants to take the "first case." Another problem is that often the damages, though real, and of significant amount to the family, are not substantial enough to interest a lawyer who would be paid only a percentage of the recovery on a contingent basis.

Or maybe the advisors and institutions that have made mistakes in this area have settled up with their aggrieved participants and beneficiaries, so the matter never gets into the case books.

Whatever the reason, there is not any established path to recovery of damages for cases of mistaken advice or messed up paperwork in this area. If you have information regarding any real cases where suit was brought and/or a settlement paid, and/or the name of any lawyer who is willing to advise and represent participants and beneficiaries with this type of claim, please let me know!

IV. THINGS YOU NEED TO KNOW TO APPLY THE PRECEDING PARTS

Certain concepts come up over and over in the area of IRA mistakes and the ways to correct them. This PART IV should make it easier to understand the preceding three parts.

❦4.1 Recharacterization Deadline: Due Date Including Extensions

The deadline for recharacterizing an IRA contribution (see ❦3.6) is the due date of the individual's tax return for the applicable year *including extensions of time.* § 408A(d)(6), (7). So:

1. A <u>regular contribution</u> to either a Roth IRA or a traditional IRA for a particular year, that was made by the *unextended* due date of the return for that year, can be recharacterized by the *extended* due date of the return for that year.

2. A <u>conversion contribution</u> to a Roth IRA may be recharacterized by the extended due date of the return for the taxable year in which the *distribution* that was converted to a Roth was distributed (which may or may not be the year the distribution was contributed to a Roth IRA; see ¶ 5.6.05(B) of *Life and Death Planning for Retirement Benefits*), and not the year the *recharacterization* occurred.

As a deadline for making certain elections, "due date including extensions" or "extended due date" has a special meaning under IRS regulations. The taxpayer does not actually have to get an

extension of his income tax return in order to go beyond April 15 for his recharacterization decision. Reg. § 301.9100-2(b) provides an automatic six-months extension (from the *unextended* due date of the return) for all "regulatory or statutory elections whose due dates are the...due date of the return including extensions *provided* the taxpayer timely filed its return for the year the election should have been made and the taxpayer takes" necessary corrective actions (such as filing an amended return if necessary). Emphasis added.

Meaning of "April 15"

The deadline for filing an individual's income tax return is the 15th day of the fourth month following the end of the individual's taxable year. § 6072(a). That means April 15th for most people. However, the actual deadline will be a bit later if April 15th falls on a weekend or holiday. § 7503. Also, the deadline may be extended for individuals in an area affected by a disaster; and of course the deadline is different for an individual whose taxable year is not the calendar year. In this Outline, "April 15" is used as shorthand for "the unextended due date of the individual's income tax return for the year in question, whatever that may be."

What's confusing is that there are two different "automatic" six-month extensions, neither of which is totally automatic. Any taxpayer can obtain an "automatic" six months' extension of time to file his income tax return (i.e., to October 15 instead of April 15)—but it's not truly automatic because to get this extension the taxpayer has to request it by April 15th, usually by filing Form 4868. Reg. § 1.6081-4.

Then there's the "automatic" six months extension of time to recharacterize an IRA contribution. This extension *is* automatic in the sense that the taxpayer doesn't have to request it; but to qualify for this automatic extension he has to "timely" file his income tax return. "Timely" filing the income tax return means filing the return by April 15 (*or* getting an extension of time to file from the IRS, and then filing the return by the extended due date).

Putting all these rules together, we find that if a taxpayer wants to recharacterize a regular IRA or Roth IRA contribution made for Year 1, or the Roth conversion of a Year 1 distribution, he must complete the necessary actions by whichever one of the following deadlines applies:

✓ **October 15 if return is timely filed.** If he files his income tax return for Year 1 on or before its due date, he has until October 15 of Year 2 to complete the recharacterization. The "due date" of the Year 1 income tax return is April 15, Year 2, *unless* he obtains an extension of time to file the return, in which case the due date is whatever date the return was extended to. For example, if, on or before April 15, Year 2, he filed Form 4868 with the IRS requesting the "automatic" six months extension, the due date of his Year 1 return is October 15, Year 2. However, *regardless* of whether he got an extension of time to file his income tax return, as long as he filed the income tax return by whatever date it was due, the deadline for recharacterizing his IRA contribution is October 15, Year 2, under the automatic extension rule of Reg. § 301.9100-2(b).

✓ **April 15 if return is filed late.** If the individual does not file his income tax return for Year 1 on or before the date it is due (whether that is April 15 or some later date he qualified for under an extension), he must complete the recharacterization by April 15 of Year 2.

If the individual misses whichever deadline is applicable, see ❦3.7.

❦4.2 How to Compute Earnings on Returned or Recharacterized Contributions

One requirement that must be met in order for a returned IRA or Roth IRA contribution to qualify for the special income tax and penalty-avoidance treatment applicable to "corrective distributions" (❦3.1) is that the "net income attributable" to the contribution must also be distributed (along with the returned contribution) by the applicable deadline. § 408(d)(4)(C). Similarly, to recharacterize an IRA contribution (see ❦3.6), not only the original contribution but also *any net income attributable to such contribution* must be transferred to the other type of IRA. § 408A(d)(6)(B)(i); Reg. § 1.408A-5, A-2(a).

This section explains how to compute the net income attributable to an IRA or Roth IRA contribution for purposes of a corrective distribution or recharacterization.

Note that the "net income" may be a negative amount—a loss, in other words. See Reg. § 1.408A-5, A-2(b); A-2(c)(6), Example 1, and "Fouad Example" below.

There are two ways to compute the net income attributable to an IRA contribution:

Method 1: If the contribution in question was made to a separate IRA (traditional or Roth) that contained no other funds, *and* there have been no other contributions to or distributions from that separate IRA, you satisfy the requirement of returning the contribution and net income attributable thereto by:

✓ For a corrective distribution, distributing the entire account balance to the participant. § 1.408-11(a)(2).

✓ If the entire contribution is being recharacterized, transferring the entire account balance to the other type of IRA. Reg. § 1.408A-5, A-2(b); see Fouad Example below.

Because Method 1 is much simpler to apply than Method 2 (below), there is an advantage to keeping each year's Roth IRA conversion contributions in a separate Roth IRA account (not commingled with any pre-existing Roth IRA), until the deadline for recharacterizing such contributions has passed.

Method 2: If Method 1 is not available, then the net income attributable to the contribution must be calculated using the following formula (Reg. § 1.408-11(a)(1)):

$$\text{Net Income equals: Contribution x } \frac{(\text{Adjusted Closing Balance} - \text{Adjusted Opening Balance})}{\text{Adjusted Opening Balance}}$$

See the regulation for details on this formula, and see Reg. § 1.408A-5, A-2(c)(6), for examples of applying the formula to Roth recharacterizations.

For purposes of applying this formula, IRAs are *not* aggregated; earnings are computed only with respect to the actual account to which the contribution was made, even if the individual owns multiple IRAs. Reg. § 1.408-11(a)(2), § 1.408A-5, A-2(c)(4).

Fouad Example: Fouad converted $200,000 from his 401(k) plan to a new separate Roth IRA in January, Year 1. This Roth IRA contained no other funds, received no other contributions, and made no distributions. By November, Year 1, the account had declined in value to $160,000, and he decided to recharacterize. He closed the Roth IRA and transferred its entire value ($160,000) to a traditional IRA. He has successfully recharacterized his entire conversion, because he transferred to the traditional IRA the $200,000 contribution plus the "earnings thereon"; the "earnings" were a loss of $40,000. He can then "reconvert" this IRA to a Roth in Year 2 (see ❦3.6, subsection 5.6.07).

❦4.3 "Regular Contribution" Versus "Rollover Contribution"

Generally, a retirement plan distribution is not included in anyone's gross income if the distribution is "rolled over" to the same or a different "eligible" retirement plan or IRA, if various requirements are met. § 402(c)(1), § 408(d)(3). If the **rollover** meets all the requirements, but the recipient account is a *Roth IRA*, the rollover (Roth conversion) is a valid rollover but it is *taxable*; see ¶ 5.4.03, ¶ 5.4.04, of *Life and Death Planning for Retirement Benefits*. For the requirements of a valid rollover, see ¶ 2.6.02–¶ 2.6.06 of *Life and Death Planning for Retirement Benefits*; for ways to avoid these requirements in some situations, see ¶ 2.6.07–¶ 2.6.08.

A "**rollover contribution**" to an IRA is a contribution that comes into the IRA account by means of a direct rollover (plan-to-plan transfer from a nonIRA plan) or indirect (60-day) rollover (see ❦4.4).

The term "**regular" IRA contribution** normally means a permissible annual-type contribution to the IRA from compensation income; see ¶ 5.3.02 of *Life and Death Planning for Retirement Benefits*. However, the regulations say that *any* contribution to a Roth IRA that is not a qualified rollover contribution is a "regular contribution." Reg. § 1.408A-3, A-1. So certain contributions that are intended to be rollovers or Roth conversions, but don't meet the rollover requirements, such as a "failed conversion" (❦2.1), would be categorized as "regular" Roth IRA contributions. A so-called regular contribution arising out of a failed conversion will typically be an excess contribution (❦2.2).

Adding to the confusion, a proper and legal tax-free rollover from a "designated Roth account" (DRAC) in a 401(k), 403(b), or 457(b) plan to a Roth IRA is treated as a "regular contribution" to the Roth IRA for purposes of applying the Ordering Rules (see ¶ 5.7.08(C) of *Life and Death Planning for Retirement Benefits*)!

❦4.4 "60-day Rollover" Versus "Trustee-to-trustee Transfer"

In a trustee-to-trustee transfer, assets are moved directly from one tax-favored retirement plan into another such plan, without the intervening step of being distributed out of the plan to the participant or beneficiary. The distribution check is payable to the receiving plan, not to the participant or beneficiary; the funds spend no time in a taxable account. The book *Life and Death Planning for Retirement Benefits* deals with only certain types of trustee-to-trustee transfers: Transfers from one IRA directly into another IRA in the name of the same participant or beneficiary (see ¶ 2.6.08, ¶ 4.2.02(B)) (usually called, in this Outline, **IRA-to-IRA transfers**); Roth conversions (¶ 5.4.07, #2); recharacterizations (¶ 5.6.03,#1); and **direct rollovers** (see below). Transfers directly from one nonIRA plan to another nonIRA plan are beyond the scope of the book.

A **direct rollover** is a particular kind of trustee-to-trustee transfer. It is the transfer of assets directly from the participant's account in a qualified retirement plan (QRP), 403(b) plan, or governmental 457(b) plan ("nonIRA plan") to an account for the benefit of the participant or beneficiary in a traditional or Roth IRA or in another eligible nonIRA plan. A direct rollover may be carried out for the benefit of the participant (upon retirement, for example) or for the benefit of a Designated Beneficiary (if the participant is deceased).

A direct rollover of nonIRA plan benefits of a nonspouse Designated Beneficiary can be made only to an IRA or Roth IRA, not any other type of plan; see ¶ 4.2.04 of *Life and Death Planning for Retirement Benefits*. The Code calls this a **direct trustee-to-trustee transfer**. § 401(a)(31)(A). The IRS (and this Outline) call it a **direct rollover**. See, *e.g.*, Reg. § 1.401(a)(31)-1. For details about the rights of a participant or beneficiary to have nonIRA benefits transferred via direct rollover to an IRA, see ¶ 2.6.01(C) of *Life and Death Planning for Retirement Benefits*.

The IRS calls a distribution from a plan or IRA to the participant (or his surviving spouse), followed by the participant's (or spouse's) redepositing the distributed amount into the same or another plan or IRA a **60-day rollover** (because of the deadline normally applicable for completing the rollover; see ❦1.5); see Reg. § 1.402A-1, A-5(a); or **indirect rollover** (see, *e.g.*, Reg. § 1.402A-1, A-4(b)).

Does the 60-day Deadline Apply to Transfers?

A case can be made that the 60-day rollover deadline does not apply to trustee-to-trustee transfers; since there is no "distribution" involved, there is no deadline by which the "distribution" must be put back into a retirement plan. Accordingly if the check from the transferring plan is payable to *the recipient plan* rather than being payable to the *individual participant or beneficiary*, one line of reasoning holds that (because you are dealing with a trustee-to-trustee transfer) the 60-day deadline *does not apply*. If this reasoning is correct, the check can be delivered to the payee-plan (or IRA) to complete the transfer, even AFTER the 60-day deadline has passed—even if the participant died after the check was cut but before it was deposited!

I have found five IRS private letter rulings that deal with this issue. Unfortunately they are not consistent.

In PLRs 2010-05057 and PLR 2010-35044, the IRS ruled that, if the distribution check is made payable to the recipient plan, and is not payable to the participant personally, the participant never received a distribution subject to the 60-day rollover requirement—even if the actual physical

check was delivered to the participant. However, three other rulings (two earlier than 2010 and one later) held that the 60-day deadline *did* apply to transfers: PLRs 2004-24009, 2004-39049, and 2013-11041. Since we now have three out of five rulings saying the 60-day deadline does apply, and one of them is the most recent of the five, it looks like the "60-day deadline applies" side is winning the debate.

Appendix A: Recommended Publications

For "ERISA" law or other matters related to retirement plans that are primarily of importance to the plan administrator, plan trustee, and employer, and any other retirement plan question not covered by *Life and Death Planning for Retirement Benefits* (7th ed. 2011), consult the easy-to-navigate well-written ***Pension Answer Book**,* by Stephen J. Krass, Esq.; I strongly recommend it as the best resource for us non-ERISA specialists regarding retirement plan legal and tax issues. It covers "employer" issues such as the design, funding and qualification of retirement plans, as well as other pension topics, such as QDROs, prohibited transactions, life insurance in plans, etc.. www.aspenpublishers.com.

I also highly recommend Denise Appleby's "**IRA Quick Reference Guides**." This is an annually-updated collection of charts (in a handy spiral-bound binder) neatly summarizing such subjects as what plan can be legally rolled over into what other plan, the current limits on contributions to every type of plan, and the distribution options/requirements for inherited plans and IRAs. You will find yourself using these "cheat sheets" more than you expect. Purchase at http://www.applebyconsultinginc.com/. Denise also offers consulting services and a free newsletter.