IRA Mistakes 2018-2.wpd 3/29/18 11/8/18

~~IЯA~~ IRA MISTAKES & HOW TO FIX THEM

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Some material in this Seminar Outline is excerpted from the 7th ed. (2011) of the book *Life and Death Planning for Retirement Benefits* as well as the forthcoming 8th ed. (Ataxplan Publications) by Natalie B. Choate. The book is published in a paperback edition (which may be ordered by calling 800-247-6553, or on line at www.ataxplan.com, for $89.95 plus shipping) and in an electronic edition by subscription ($9/month, cancel any time; visit www.retirementbenefitsplanning.com). All rights reserved. The text contains cross references to portions of the book (indicated by the "¶" symbol) that are not reproduced in this Outline and that may provide further explanation of topics that are touched on in this Outline.

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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; the section may or may not also be included elsewhere in this Outline (see the Table of Contents)

§ 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 February 28, 2018.
DOL	Department of Labor.
ERISA	The 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. § 401(a)(9).
Reg.	Treasury Regulation.
Roth IRA	A Roth IRA established in accordance with § 408A of the Code.
TCJA 2017	The "Tax Cuts and Jobs Act," signed into law 12/22/2017 (P.L. 115-97).
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 does not cover the 10 percent tax on early distributions (§ 72(t)) or (in depth) prohibited transactions.

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 one-volume resource regarding retirement plan legal and tax issues. It covers 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.

IRA MISTAKES & HOW TO FIX THEM

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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. MISTAKES YOU CAN MAKE WITH AN IRA

❦1.1 Attempted Rollover or Roth Conversion of the RMD

A required minimum distribution (RMD) is not eligible to be rolled over; it is not an eligible rollover distribution. § 402(c)(4)(B); § 408(d)(3)(E). By the same token, an RMD cannot be "converted" to a Roth IRA. That's because a Roth conversion is considered a rollover; essentially a Roth conversion is a taxable rollover. What's more, the first distribution(s) in any year are counted towards the RMD for that year, and deemed to be part of the RMD, until the RMD has been entirely distributed. Reg. § 1.402(c)-2, A-7(a), § 1.408-8, A-4. The conclusion, therefore, is that, in any year for which a minimum distribution is required from a particular plan or from the individual's IRA(s), the individual cannot roll over (or convert to a Roth) any distribution from such plan or any IRA until after he has completed taking his RMD for the year out of the applicable plan or account.

Bogey Example: In Year 1, Bogey turns age 73. He owns an IRA that was worth $1 million on 12/31 of the prior year 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 Year 1 prior to doing the Roth conversion. What's the problem and what's the remedy?

IRS regulations contain a specific rule covering this exact scenario. Reg. § 1.408A-4, A-6. 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. 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 Year 1 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"; see ❦4.3), he has an excess IRA contribution problem. See ❦2.2.

Darlene Example: In Year 1, Darlene's RMD from her company's 401(k) plan is $10,000. Before taking any other distributions in Year 1, she arranges for $30,000 to be transferred via "direct rollover" to her IRA. The 401(k) plan administrator should not have allowed this; the plan administrator should have distributed the $10,000 RMD to Darlene personally before making any direct rollover transfers into her IRA, but it happened. What is the problem and what is the remedy?

As with Bogey's attempted Roth conversion, the first fact to note is that Darlene's RMD WAS distributed from the 401(k) plan, so there is no worry about a penalty for failure to take the RMD: "...[I]f an amount is distributed by one plan and is rolled over to another plan, the amount distributed is still treated as a distribution by the distributing plan for purposes of section 401(a)(9), notwithstanding the rollover." Reg. § 1.401(a)(9)-7, A-2. The fact that the RMD was improperly rolled into an IRA does NOT "cancel out" the fact that the RMD did come out of the first plan. So Darlene's problem is an excess IRA contribution. See ❦2.2.

Where to read more: 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

The mistake: 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. Since 2010, when Roth conversions became legal for all income levels, this particular problem has become rare; after 2018 it will become virtually extinct. Here is how it can happen (or could have happened) 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. Since 2010 this cause of failed conversions has become obsolete.

✓ 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**, ¶ 5.6.03, Step 5). Since Roth conversions occurring after 2017 cannot be recharacterized (see ❦**3.6**, ¶ 5.6.08), this cause of failed conversions will also become obsolete.

In both 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 could be useful in reversing an undesired pre-2018 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 prior to 2018, 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*.

Since recharacterizations will not be allowed for post-2017 Roth conversions (see ❦**3.6**, ¶ 5.6.08), this potential headache for executors will soon be obsolete.

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, see ❦3.6, ¶ 5.6.09.

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 an IRA contribution (see ❦3.6), which is a way to undo a Roth IRA contribution or pre-2018 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 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 investment in the contract.

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 the applicable year, 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 a Roth IRA, *if* Percy could have validly rolled that $400,000 Roth IRA distribution into a Roth IRA. See ❦3.6 for the requirements for a valid recharacterization. Recharacterization is not normally available for tax-free "rollovers" (other than rollovers that are Roth conversions), but Percy's IRA contribution did not qualify as a tax-free "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. See the following paragraphs 2.7.01—2.7.04.

If the client does not fit into any of these exceptions, see ❦2.5 and ❦3.5.

*2.7.01 **Computation of the 60 days***

A rollover generally must be completed no later than "the 60th day following the day on which the distributee received the property distributed." § 402(c)(3)(A); § 408(d)(3)(A).

Unlike the due date for tax returns, the 60-day deadline is apparently not eligible for the automatic extension of time (under § 7503) to the next business day if the 60th day falls on a weekend or holiday. The IRS has granted hardship waivers of the deadline (¶ 2.7.07) in several cases where the deadline fell on a weekend or other "bank holiday." See PLRs 2006-06055, 2009-30052, 2009-51044, 2009-52066, and 2010-39041.

The deadline is 60 days, not two months. A distribution made on March 12th must be rolled over by May 11th; May 12th is too late. PLR 2005-23032.

2.7.02 ***Does the 60-day deadline apply to direct transfers?***

When an employee requests a direct rollover from a nonIRA plan to another plan or to an IRA (see ¶ 2.6.01(C)), IRS rules require the distributing plan to make the distribution check payable to the transferee plan or IRA, but permit the distributing plan to send or give the check *to the employee*. Reg. § 1.401(a)(31)-1, A-4. It sometimes occurs that the employee for whatever reason fails to deliver the check to the recipient plan or IRA within 60 days.

The IRS has privately ruled that the 60-day deadline does not apply to direct rollovers, so the employee (or his executor, if the employee died holding the un-deposited check) can complete the rollover (even more than 60 days after the check was sent out from the transferor plan) by simply depositing the check into the recipient plan or IRA account. See PLR 2010-05057 ("The distribution check was given to Taxpayer A, but made out to Company B, FBO Taxpayer A; thus the check was not payable to Taxpayer A and Taxpayer A lacked control over the check and could not have disposed of it.…*In short, Taxpayer A never received a distribution subject to the 60-day rollover requirement*…" (emphasis added)) and PLR 2010-35044 (because this distribution was in the form of a direct rollover, "it was not subject to the 60-day rollover requirement," therefore no "hardship extension" (¶ 2.7.07) was needed to enable the executor to deposit the plan's check).

These two 2010 PLRs reversed the IRS's earlier position, which was that a hardship extension (deadline waiver) *was* required to allow completion of a direct rollover if the check had not been deposited within 60 days. See PLRs 2004-24009 and 2004-39049.

But that was 2010. Fast forward to 2013. In PLR 2013-11041, the participant requested direct rollover of her funds from her employer's Plan X into an IRA. Plan X issued two checks payable directly to the custodian of the participant's IRA, but mailed the checks to the participant, unfortunately to the wrong address. The participant did not receive the checks in time to deposit them into the IRA within the 60-day deadline. The IRS granted her a waiver of the deadline due to the company's error. Forgotten are the two 2010 PLRs that said the 60-day deadline doesn't apply to a direct rollover!

2.7.03 ***How does the 60-day deadline apply to lost checks?***

What if the participant never receives the check the plan sends him? The IRS has issued inconsistent PLRs on this one also. In PLRs 2004-30031 and 2004-36017, the IRS ruled that, if the distribution check is never received, there has been no distribution (the 60-day rollover period, in PLR 2004-30031, being measured from the date of the replacement check that the plan issued to replace the lost check). But then in PLR 2004-47042 the IRS ruled that the 60-day rollover deadline was measured from the date of the original (lost) check, *not* the date of the replacement check. § 408(d)(3)(A)(I)) says the deadline is "the 60th day after the day on which he [i.e., the participant or surviving spouse] *receives* the payment or distribution." Emphasis added. Reg. § 1.408-4(b)(1) says the same. So, based on the Code and its own regulation, the IRS was right in PLRs 2004-30031 and 2004-36017 and wrong in 2004-47042.

In 2013, the IRS reverted to the correct position: In **PLR 2013-30047**, the participant was notified by his plan in December 2, Year 1, that it had sent him a check for his benefits. He notified the plan that he had not requested a check and furthermore he never received the check. On February

29, Year 2(?), the company sent him a replacement check, which he deposited on the following March 30 into an IRA account. He sought a waiver of the 60-day rollover deadline (apparently assuming that the date of the distribution was the date the *first check* was supposedly sent to him), on the grounds that he had been the full time caregiver of "Individual B" during this period. The IRS denied the waiver on the grounds that he didn't need one because he had completed the rollover within 60 days of the distribution!

2.7.04 Non-hardship exceptions to the 60-day deadline

There are several exceptions to the 60-day deadline. The most significant one is that an individual may obtain a "hardship waiver" of the deadline; see ❦3.5 Here are other less commonly seen exceptions:

A. **First-time homebuyer.** There is a 120-day deadline rather than a 60-day deadline for the rollover of a "first-time homebuyer" distribution (¶ 9.4.09) 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 once-per-12-months rule (¶ 2.6.05).§ 72(t)(8)(E); PLR 2004-23033.

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; ¶ 9.4.12) 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 active duty period. § 72(t)(2)(G). The rollover contribution of a QRD 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 his plan without regard to the normal limits on IRA contributions (¶ 5.3.03). 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.

D. **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).

E. One-year deadline for certain financial institution errors. The 60-day deadline is *automatically* extended to one year if: 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 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 distribution. Provided the funds are deposited in the eligible plan within one year of the distribution, there is an automatic waiver of the 60-day rollover deadline. Rev. Proc. 2003-16, 2003-1 C.B. 359, § 3.03. It is not clear whether this "automatic" extension will be subsumed into the self-certification procedure (❦3.5, 2.7.06).

❦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 changed 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).

"One distribution" can be paid in several instalments?

Suppose Chris asks his IRA provider "Company X" to close out his IRA and send him the proceeds, so that Chris can roll the distribution over to an IRA at a different company, "Company Y." Company X sends Chris a check immediately for all the cash in his IRA, then a few weeks later, after selling all the various investments in the account, sends him a second check for the balance of the account. Is that one distribution or two?

In **PLR 2011-05047**, we are told that Taxpayer A received "*distributions* of *amounts* from IRA X totaling Amount D" that he sought to roll over. Emphasis added. "*On Date 1*, Taxpayer requested a total distribution of Amount D from IRA X. On the following day, Taxpayer A received most of the balance of IRA X and, *on Date 2*, Taxpayer received a check for the remainder of the balance of IRA X." Taxpayer intended to roll over "Amount D" to another IRA he had already established, but due to a series of family emergencies, paperwork snafus, and a serious medical condition, he missed the deadline.

The IRS allowed a late rollover for BOTH of the "distributions...totaling Amount D." Although the rule of § 408(d)(3)(B) is recited in the ruling, the IRS does not seem to view it as applying to Taxpayer A's "distributions." Is that because he requested a total distribution? If you request a total distribution and the IRA provider pays it out to you piecemeal it is still considered one single distribution for purposes of the one-rollover-per-12-months rule?

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).

- ♦ 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 require 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. See ¶ 4.2.04 of *Life and Death Planning for Retirement Benefits* (7th ed. 2011).

✓ 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. ¶ 4.2.02(B) of *Life and Death Planning for Retirement Benefits* (7th ed. 2011).

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 minutes. 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: Proposed Tax Legislation

Former President Obama issued various proposed budget and tax law changes while he was in office. One change he proposed would have permitted 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 *could* be treated as a taxable distribution from the nonIRA plan followed by an excess contribution to the inherited IRA; but see ❦3.6, 5.6.09, for how to possibly fix this mistake by recharacterization.

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. § 408A(c)(6)(A); see ¶ 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 presumably be treated as a distribution from the inherited traditional IRA, followed by an excess contribution to the inherited Roth IRA, unless it is "recharacterized" back into the inherited traditional IRA (see ❦3.6, 5.6.09).

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 would presumably be 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). This mistake may be fixable by recharacterization (see ❦3.6, 5.6.09) or hardship waiver of the rollover deadline (see ❦3.5).

<u>Where to read more</u>: 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 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 regular IRA contribution, or 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 types of 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). (Actually, these are "excise taxes" or "additional taxes," not "penalties," but are popularly called "penalties" by just about everybody including the IRS.) All the punishments listed here are variations or combinations of those weapons.

❦2.1 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 ("undone") a pre-2018 Roth conversion attempts to "reconvert" the same recharacterized 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). But see ❦3.6 for the possibility of using recharacterization to fix the mistake in some cases.

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 at all). 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 [Service Center Advice] 2001-48051 and ❦2.7.

✓ The deemed distribution apparently does count towards satisfying 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 valid 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. See ❦4.3 for more discussion.

A direct plan-to-plan transfer from one IRA to another IRA, 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; see also Instructions for IRS Forms 5498 and 1099-R.

Regular IRA and Roth IRA contributions are limited:

✓ <u>Who can contribute</u>: 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. § 219(d)(1). An individual cannot make a regular contribution to a Roth IRA in a year in which his income exceeds certain amounts. § 408A(c)(3).

✓ <u>How much can be contributed</u>: 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 annual dollar limit for

2014–2017 IRA contributions was $5,500 ($6,500 if age 50 or older by the end of the contribution year).

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).

❦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 "investment in the contract" 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 (to the extent it is includible in gross income) also 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 Code's 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* (see "Recommended Publications" on p. 6 of this Outline).

- 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 from such account in an amount equal to the cost of such collectible." § 408(m)(1). The treatment then becomes somewhat mysterious. According to a never-finalized proposed regulation, the subsequent distribution of the collectible item itself would not be taxed to the extent of the previously-taxed deemed distribution. See Prop. Reg. § 1.408-10(g). What if the collectible is sold inside the IRA? Does the IRA owner still have "basis" (investment in the contract) in the IRA to the extent of the already-taxed income (by analogy to the treatment of plan loans; see ❦2.4)? We do know that the deemed distribution of a collectible from an IRA cannot be corrected by rollover: The forbidden collectible cannot be rolled back in to an IRA, but to have a valid rollover the participant could not substitute cash (or anything else) for the collectible. ❦1.6.

❦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* (see "Recommended Publications," p. 6 of this Outline).

A plan loan that fully 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 that does not meet those requirements, or that only partly meets such requirements, or that ceases to meet those requirements, would generate a "deemed distribution," and even a § 72-compliant plan loan can generate a deemed "offset distribution." "Deemed" and "offset" distributions have very different tax consequences. When the deemed "distribution" results from a default under the plan loan it is not always clear which type it is (deemed or offset).

A "deemed distribution" under § 72(p) cannot be rolled over, and thus this particular type of 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 repayment due date 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. The Tax Cuts and Jobs Act of 2017 made a statutory change lengthening the rollover period for offset distributions caused by the termination of the plan or of the employee's termination of service—the deadline for rolling over the deemed distribution is the extended due date of the employee's tax return for the year of the distribution. See ❦4.1,

- ✓ 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 generally 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) but in some cases may be fixable by recharacterization (see ❦3.6, ¶ 5.6.09).

- ✓ The participant believes he has successfully 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") and (in some cases) ❦3.6, ¶ 5.6.09 (recharacterization).

❦2.6 Punishment 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 excise tax for missing an RMD is imposed on the "payee" (nonpayee?) 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 excise tax for failure to take the RMD falls on the [non?] 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. Note: This requirement does *not* apply to inherited IRAs. The IRA provider's obligations with respect to RMD compliance end when the participant dies. Beneficiaries are totally on their own!

The Code imposes an excise tax for failure to take an RMD. The tax is 50 percent of the amount that was supposed to be, but was not, distributed. § 4974(a). For how to compute this tax, see Reg. § 54.4974-1, -2.

The excise tax 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 the excise tax 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 return. 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 (2016), 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 (2016), p. 32 (Schedule G, line 7) and Form 5329 (2016), p. 1.

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 (2016), line 52, and Instructions (p. 8). Evidently 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 the missed RMD is taken.

Since normally the individual or fiduciary will want to seek a *waiver* of the excise tax, Form 5329 should be used not to pay the excise tax but to request the waiver. SEE SECTION ❦3.8 OF THIS OUTLINE BEFORE COMPLETING AND FILING FORM 5329 FOR A MISSED RMD.

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; see ❦3.8(D) below.

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

§ 72(t) imposes a 10 percent excise tax on retirement plan distributions made to a participant who is younger than age 59½. Generally, the excise tax 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 excise tax despite the recipient's young age).

To learn about this excise tax, see Chapter 9 of *Life and Death Planning for Retirement Benefits* which explains the excise tax and its exceptions. A free resource is IRS Publication 590-B.

❦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 permitted 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 punishment for an IRA prohibited transaction. The punishment imposed 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 examples of IRA prohibited transactions:

In Advisory Opinion (AO) 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 AO 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 AO 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 stirred up such a ruckus that the IRS 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 AO 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 AO 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 AO 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 sometimes-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. However, the list of "unknown issues" is shrinking, and the IRS has recently had growing success in the arena of punishing prohibited IRA 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* (see "Recommended Publications," p. 6 of this Outline). 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 punishment for a prohibited transaction involving the IRA owner or beneficiary is disqualification of the IRA, if a client has decided to go ahead with an investment that may involve PT exposure, 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, though this assumption has never been tested.

III. THE LADDERS: WAYS TO FIX THINGS

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

We start with the "corrective distribution" escape hatch, which can enable a person to avoid the excise tax for an excess IRA contribution: You can avoid the excise tax by taking out of the IRA a certain amount by a certain deadline. The amount that must be removed is, the excess contribution itself, plus any "earnings" that have accrued on the contribution between the date of the contribution

and the date it is removed. The deadline for completing this corrective distribution is the extended due date of your tax return for the year the contribution was made. If you remove the correct amount by that deadline, two good things happen. First, the returned contribution is not income-taxable, i.e., it is not includible in your adjusted gross income. Second, the contribution is deemed not to have been made at all for purposes of the six percent excise tax, so you wipe out the excise tax.

What if you made an excess contribution but miss the deadline for the excise tax-free cleanup? You still need to "fix it," but the method and timing are different. Read on...

❦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 excise tax on premature distributions (see "E"), and for purposes of the excise tax 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-A (*Contributions to IRAs*), 2015.

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 change his mind and withdraw that contribution by one of the following deadlines: If he files his Year 1 tax return on time [meaning either by April 15, or—if he obtained an extension of time to file—by October 15, of Year 2] he can withdraw the contribution until October 15 of Year 2. If he fails to file his Year 1 tax return on time, his deadline for withdrawing the corrective distribution is April 1 of Year 2. See ❦4.1 for explanation of this deadline. The contribution can be withdrawn before or after the filing of the return, as long as the withdrawal is made by the applicable deadline.

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 he must file an amended return.

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 investment in the contract and the earnings thereon, with all of the owner's 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 investment in the contract (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 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, the general definition of gross income. Accordingly 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") is 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). What the IRS has yet to clarify is whether "year in which" means the actual calendar year in which the contribution occurred or the taxable year for which the contributions was made.

E. 10 percent excise tax treatment

Because the returned contribution is not taxable under § 72 (see "D"), it is not subject to the 10 percent excise tax on pre-age-59½ distributions (§ 72(t); see ❦2.7). However, according to the IRS the net income that is returned with the contribution (see "B"), which is income-taxable (see "D"), *is* subject to the 10 percent tax 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, contributed $3,000 to a new IRA in Year 1. Wayne made no other contributions to, and took no distributions from, the IRA. By Year 2, the investments in the IRA had earned $75 of interest. Wayne then cashes out the account in March of Year 2, prior to the due date of his Year 1 tax return, receiving a distribution of $3,075. The $75 of earnings are included in his gross income for the year of the contribution (Year 1), *not* the year they are distributed (Year 2), and the 10 percent excise tax ($7.50) on those earnings is payable for Year 1 unless an exception applies.

I Disagree with the IRS

In my opinion, the 10 percent excise tax should not apply to the earnings distributed as part of a corrective distribution. A corrective distribution is not taxed as a retirement plan distribution: It is not subject to the "cream-in-the-coffee rule," nor (apparently) is it treated as a distribution for purposes of the rule that the first distribution of the year "counts" as the RMD (see Reg. § 1.402(c)-2). The purpose of the excise tax is to prevent people from taking advantage of the tax-deferred or tax-free accumulation of funds inside the IRA, then using the money 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 excise tax

A six percent excise tax 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 excise tax. 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 excise tax. § 4973(b) (second to last sentence), § 4973(f) (last sentence).

G. Corrective distribution example

Lola Example: Lola's father died in Year 1, leaving his $300,000 401(k) plan (all pretax money) to Lola (age 48) as Designated Beneficiary. In Year 2, 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 Year 2, the year the distribution occurred. The transfer of funds into her own IRA is considered a "regular contribution" to that account in the same year (see ❦4.3). Assume the maximum regular contribution Lola can legally make to her own IRA for Year 2 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 15, Year 3 [the extended due date of her Year 2 tax return], to avoid being liable for a six percent excise tax ($17,700) on the $295,000 excess contribution. See ❦2.2, ❦3.1. Assume

she withdraws the excess contribution and income thereon in early Year 3. Here is how she will report these transactions on her Year 2 tax return: She will include in gross income a $300,000 distribution from the inherited 401(k) plan. Though includible in her income, this distribution is not subject to the 10% excise tax because the excise tax does not apply to death benefits; § 72(t)(2)(A)(ii). She will also report additional income of $12,000 (the earnings on the excess contribution) as income in Year 2 (even though she received it in Year 3). This additional income is subject to the 10% excise tax in Year 2 (see "D" and "E" above). Finally, she will report a $5,000 "regular" contribution to her own IRA for Year 2.

The "Lola" example is intended solely to illustrate how the excess contribution excise tax and correction would work. Before accepting "excess contribution" treatment, Lola should consider whether she could "recharacterize" the contribution as a contribution to an inherited IRA (❦3.6, 5.6.09) or obtain a "hardship waiver" of the rollover deadline to allow the rollover to be done correctly (❦3.5).

❦3.2 Quasi-Corrective Distributions

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

But the excess contribution excise tax 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 excise tax 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 excise tax 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 (2016), pp. 5–6 ("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, with example

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 excise tax 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 a later year's legal "regular" 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 ❦3.1(D)) unless the limited exception described at ❦3.2 applies. On the "bright" side, the excess contribution is added to the participant's investment in the contract in the IRA; see, *e.g.*, PLR 2009-04029.

Barbara Example: Barbara contributed $7,500 to her IRA in 2014. She was only eligible to contribute $5,500. She failed to withdraw the $2,000 excess contribution and its earnings by October 15, 2015, the extended due date of her 2014 tax return. She owes the excise tax ($120, which is 6% of $2,000) for the year 2014. In November 2015 she discovers her mistake and withdraws the $2,000 excess contribution (but *not* the earnings thereon) before the end of 2015. The good news is, since the excess contribution was withdrawn before the end of 2015, she does not owe another excise tax for 2015. The bad news is that this late "correction" is not entitled to the special income tax-free treatment granted to timely corrective distribution. Accordingly her $2,000 distribution will be taxed the same as any other IRA distribution, i.e., it will be included in her gross income except to the extent a proportion of it constituted a distribution of any after-tax money she happens to have in her IRAs. (The $2,000 excess contribution will be part of her after-tax money in her IRAs.)

B. Effect on 6% excise tax

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 excise tax for the year the excess contribution occurred. See "Barbara Example" above. 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 excise tax 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 excise tax. 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 excise tax each year.

- The fact that the participant can eliminate the excess-contributions excise tax 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 transaction. The participant deliberately makes an excess 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 excise tax. But if the investments in the Roth account have appreciated, he allows the corrective distributions deadline to pass, pays the six percent excise 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 excise tax)—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; examples

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.

Armande Example: Armande, age 45, is eligible to contribute $5,000 to a traditional IRA in Year 1. By mistake he contributes $9,000. He has made an excess contribution of $4,000. By the time he discovers this error, in early Year 2, 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 excise tax for Year 1 ($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 excise tax 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 excise tax to avoid a $240 excise tax! He decides to pay the excess contributions excise tax of $240 for Year 1, leave the excess contribution in the IRA, and treat the Year 1 excess contribution as part of his "regular" IRA contribution for Year 2. In Year 2 he is eligible to contribute up to $5,500 to an IRA from his compensation income, so the $4,000 excess contribution carried over from Year 1 will "absorb" most of his Year 2 contribution.

D. Fixing excess IRA contribution: Bill example

Question: We have a new client, "Bill." He is single (his wife died in 2008). He reached age 70½ in 2009 and retired at the end of 2010. In each of the years 2009–2010, he earned compensation income (wages) of $50,000 and his total income was $80,000. He will have zero compensation income in this current year (2011). In each of the years 2009–2011, in January, he contributed $6,000 to a traditional IRA. This was outside of his employment, i.e., these contributions were not made to a "SEP-IRA." He has never taken any deduction for these contributions. However, it appears to us

that he was not entitled to make these traditional IRA contributions. Do you agree, and if so what can we do to repair his excess IRA contributions? Will he have to pay the excise tax? He has already filed his income tax returns for 2009 and 2010 on a timely basis.

Answer: Because Bill reached age 70½ in 2009, all his contributions to his traditional IRA in the three years 2009–2011 were "excess contributions." An individual cannot contribute to a traditional IRA on his own behalf in or after the year in which he reaches age 70½. (The traditional IRA is the only retirement plan that has an age limit on making contributions.) There is a six percent annual cumulative excise tax on excess IRA contributions. However, Bill can fix some of these excess contributions and reduce the excise tax. Let's look at each year separately.

[Regarding who is eligible to contribute how much to an IRA or Roth IRA, and the definition of "compensation" income, see § 219(c), (f); Reg. § 1.408A-3, A-3, A-4; or IRS Publication 590-A.]

2011: Withdraw the excess contribution

Bill can avoid the excise tax for 2011 by taking a corrective distribution from the IRA. He would have to withdraw the contribution he made in January 2011 along with the "net income" attributable to the contribution. The deadline for completing this corrective distribution, in order to avoid having the six percent excise tax slapped on the 2011 excess contribution is "on or before the day prescribed by law (including extensions of time) for filing such individual's return for such taxable year." That could be as late as October 15, 2012; see ❦4.1 of this Outline for more on what this deadline means. See ❦4.2 for how to compute the "net income" on an excess contribution.

The distribution to him of the returned contribution is tax-free. However, any earnings that must be distributed to him along with the returned contribution will be includible in his gross income.

2010: Recharacterize as a Roth contribution

Though Bill was not entitled to contribute to a traditional IRA in the year 2010 (because he was over age 70½), he could legally have contributed to a *Roth* IRA for that year. He was eligible to contribute $6,000 to a Roth because:

1. He had compensation income (earned income) of at least $6,000.
2. His modified adjusted gross income for 2010 was under $105,000.

Different standards apply in determining eligibility to contribute to a Roth IRA than apply to a traditional IRA. Although one must have compensation income to contribute to either type of IRA, there is an age test applicable to traditional IRA contributions (no contributions if age 70½ or older), but no age test applicable to Roth IRA contributions. There is an income test applicable to Roth IRA "regular" contributions, but no income test applicable to traditional IRA contributions (and no income test at all applicable to Roth IRA conversions).

Since Bill was not eligible to contribute to the type of IRA he contributed to, but *was* eligible to contribute to the other type of IRA, he can "recharacterize" his traditional IRA contribution as a contribution to a Roth IRA instead. He does that by moving the $6,000 contribution (plus or minus

any "earnings" thereon) out of the traditional IRA and into a Roth IRA. For more details on this remedy see ¶ 5.6.01 of *Life and Death Planning for Retirement Benefits* (7th ed. 2011).

The deadline for doing this is the same as the deadline for making a "corrective distribution" (see the 2011 discussion above), namely, the due date of his tax return including extensions. Under the IRS's regulations, that means he can make this switch up until October 15 of this year (2011) even though he has already filed his 2010 tax return (and even though he didn't actually get an extension of time to file) as long as the 2010 tax return was filed on time.

If he gets that recharacterization done on time (or withdraws the contribution and the earnings thereon altogether, if he prefers to go the "corrective distribution" route) there will be no excise tax for the 2010 excess contribution.

2009: Too late to avoid the excise tax

Since the latest possible "extended due date" of Bill's 2009 income tax return was on or about October 15, 2010, it is too late, now that 2011 is here, to either do a "corrective distribution" or to "recharacterize" that contribution. Thus Bill owes the six percent excise tax for 2009 and also for 2010, since the excise tax continues to accrue each year until the excess contribution is either distributed or "absorbed" (treated as part of a contribution for later year). He owes six percent of $6,000 ($360) for each of those years, a total of $720. He can avoid having an additional excise tax accrue (for the calendar year 2011) on account of that old excess contribution by withdrawing the $6,000 2009 excess contribution from the traditional IRA by the end of calendar 2011.

Note that he only has to withdraw the actual excess contribution ($6,000) by the end of 2011, not any earnings thereon, to stop the excise tax on that old 2009 excess contribution accruing for the year 2011. Computing "earnings" on a contribution is involved only when you are trying to do a corrective distribution or recharacterization.

Is there any possibility of getting IRS relief from this excise tax? One avenue is to request permission for a "late recharacterization" of the 2009 contribution as a Roth IRA contribution rather than a traditional IRA contribution. The IRS can grant permission for a late recharacterization if there is good cause—for example, if he was receiving erroneous professional advice about his eligibility to contribute to an IRA. See ❦3.7.

❦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 that she rolled over (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 The Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. 107-16) ("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 if applicable) 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 by the applicable 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). 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.

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.

2.7.05 ***Hardship waivers of 60-day rollover deadline: General***

A. Background: Law and IRS Pronouncements

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).

There are two ways to obtain such a waiver. If your fact situation fits into the guidelines of Rev. Proc. 2016-47, 2016-37 IRB 346, you can "self-certify" that you are entitled to the waiver. The administrator of the plan or IRA you are rolling into can rely on your certification. This is the simplest, fastest, and cheapest way to a waiver—for those who qualify for it. Self-certification is explained in ¶ 2.7.06 below.

If you don't meet the requirements for self-certification, you may still be able to obtain a waiver, but you will have to apply to the IRS for a private letter ruling to get it. ¶ 2.7.07 (below) explains the private letter ruling approach, as set out in Rev. Proc. 2003-16, 2003-1 C.B. 359.

The legislative history of § 402(c)(3)(B) (enacted in 2001) indicates that Congress wanted the IRS to issue "objective standards" for granting hardship waivers of the 60-day deadline. The IRS finally did that in August 2016 when it authorized the self-certification procedure in Rev. Proc. 2016-47; see ¶ 2.7.06 below. Prior to that date, the only IRA pronouncement (which still applies to cases not qualifying for the self-certification procedure) was Rev. Proc. 2003-16, which 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." These are more "guidelines" than "objective standards."

B. Problems with a Late Rollover Even When Waiver Is Obtained

Getting a hardship waiver does not solve all the problems caused by a late rollover: See, for example, 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* (7th ed. 2011).

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

C. Late Rollover in Year for Which an RMD Would Be Due

If the delayed rollover occurs in a year when the participant would normally have been required to take minimum distributions (because he or she was over age 70½; see Chapter 1 of *Life and Death Planning for Retirement Benefits*), the hardship waiver does not waive the required minimum distributions (RMDs). Rather, the waiver rulings typically specify that interim RMDs can *not* be rolled over despite the hardship extension. Though the rulings do not specify how that nonrollable amount is to be determined, we do know this much: "...if the amount rolled over is received in a different calendar year from the calendar year in which it is distributed, the amount rolled over is deemed to have been received by the receiving plan in the calendar year in which it was distributed." Reg. § 1.401(a)(9)-7, A-2; § 1.408-8, A-1.

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 and age 71, she was placed under guardianship and the guardian applied for a waiver of the 60-day deadline to allow the $500,000 distribution to be rolled back into the IRA. The waiver is granted by the IRS in 2008, but the waiver specifies that any RMD cannot be rolled over. How do we calculate the missed RMD?

First, there was no RMD for the year the distribution came out of the IRA, in 2007, because Polly was only 69 years old.

However, an RMD *would have accrued* in 2008 if the money had still been in the IRA, because Polly turned 70½ in 2008. To calculate the 2008 RMD, you would start by determining the prior year-end (12/31/07) account balance; see ¶ 1.2.05 of *Life and Death Planning for Retirement Benefits.* In reality there was no 12/31/07 account balance—all the money was outside the IRA on that date. However, under the IRS regulations it is assumed for purposes of computing the 2008 (and subsequent) RMDs that the $500,000 rollover was received in 2007, the year of the distribution, and therefore (apparently) the prior year-end balance for purposes of computing the 2008 RMD is $500,000. Therefore, presumably, her nonrollable hypothetical RMD for 2008 is $18,867.92 ($500,000 divided by 26.5, which is the factor for age 71 from the Uniform Lifetime Table). So her maximum permitted late rollover in 2008 is $481,132.08 ($500,000 distribution minus $18,867.92 hypothetical RMD).

There is presumably no RMD required with respect to any earnings or growth the $500,000 distribution achieved while it was *outside* the IRA (and accordingly that might have been earned inside the IRA had the distribution not occurred)—which is appropriate because Polly was taxable in 2008 on any such earnings that occurred (and she is not allowed to roll over that income "as if" it had been earned inside an IRA; see Rev. Proc. 2003-16, § 3.04).

If the late-rollover amount was "outside" the IRA for more than one year, see ❦ 2.6 regarding adjustments for hypothetical RMDs and earnings.

D. Qualified Airline Employee Rollovers

Certain **qualified airline employees** can contribute to a Roth IRA (only), within 180 days of receipt, certain payments they receive in connection with the bankruptcy of a "commercial passenger airline carrier." See § 125 of the Worker, Retiree, and Employer Recovery Act of 2008 and IRS Publication 590 ("IRAs"; 2010 ed., p. 65). This type of contribution is treated as a qualified rollover contribution to the Roth IRA. In PLR 2010-51027 the IRS ruled that it does NOT have the authority to waive or extend the 180-day deadline for these contributions.

2.7.06 ***Hardship waiver, method #1: Self-certification***

Rev. Proc. 2016-47, 2016-37 IRB 346, created a new "self-certification" procedure for obtaining a hardship waiver of the 60-day rollover deadline: If you have received a plan distribution, but you have not completed the rollover of that distribution within 60 days, you can make the rollover late, provided you certify to the administrator of the plan you are rolling over to that you qualify for a waiver of the 60-day deadline. The plan administrator can rely on your self certification and accept the rollover. The IRS has conveniently included a sample letter form in the Rev. Proc. that can be used (as is or modified) to self-certify qualification for the 60-day waiver.

A. Requirements for Self-certification, Including 11 Reasons

To qualify for self-certification, you must meet three requirements. First, you must not have been previously denied a waiver by the IRS for this particular distribution. Second, you must have been unable to complete the rollover due to one or more of the 11 reasons in the following list. Third, you must complete the rollover as soon as practicable after the reason(s) that prevented you from completing it no longer prevent you. Completing the rollover within 30 days after the "reasons no longer prevent you" will automatically be deemed to comply with condition #3.

Here is the menu of causes justifying the waiver based on the self-certification procedure:

1. An error was committed by the financial institution receiving the contribution or making the distribution to which the contribution relates.

2. The distribution was made in the form of a check which was misplaced and never cashed.

3. The distribution was deposited into and remained in an account that the taxpayer mistakenly thought was an eligible retirement plan.

4. The taxpayer's principal residence was severely damaged.

5. A member of the taxpayer's family died.

6. The taxpayer or a member of the taxpayer's family was seriously ill.

7. The taxpayer was incarcerated.

8. Restrictions imposed by a foreign country.

9. Postal error.

10. The distribution was made on account of an IRS levy under § 6331 and the proceeds of the levy have been returned to the taxpayer.

11. The party making the distribution delayed providing information that the receiving plan or IRA required to complete the rollover despite the taxpayer's reasonable efforts to obtain the information.

Of the 11 reasons, #1 is the most common reason people are forced to seek waivers of the 60-day deadline—financial institution error. Since 2001, it seems that more waivers have been issued for that reason than for all the others combined.

"Appendix A" of this outline collects some of the PLRs in which the IRS granted or denied hardship waivers of the 60-day rollover deadline, including those based on the above 11 hardships.

B. How the IRS Will Police Self-certification

The self-certification procedure is not invulnerable. If the IRS audits your return, and finds that (for example) you made a material misstatement in your certification, or the reason(s) you claimed did not in fact prevent you from completing the rollover, or you did not complete the rollover as soon as practicable once the reasons were removed, the IRS can take away the waiver of the 60-day deadline. In that case you will of course be in big trouble: You will owe income taxes on the late-rolled distribution, plus penalties for an excess contribution to the receiving plan, plus interest and penalties on the foregoing.

How will the IRS ever know that you used the self-certification procedure? Don't count on "audit roulette" to protect you from IRS scrutiny on this issue. An IRA provider must file Form 5498 annually with the IRS for every IRA it held the prior year. The IRS has revised Form 5498 (effective for the 2017 return, due May 31, 2018) so that the IRA provider will now report, in Box 13a, "the amount of a late rollover contribution made in 2017 and certified by the participant." Thus the IRS can easily identify self-certified late rollovers and presumably intends to audit some of these for compliance with Rev. Proc. 2016-47.

C. Hardships Not Included in the Menu of 11

The list of 11 hardships in Rev. Proc. 2016-47 leaves out some significant reasons that have regularly led to hardship waiver requests in the past:

✓ Error by a financial advisor who is not part of the distributing or receiving financial institution.

✓ The taxpayer's death.

✓ Mental or emotional state of the taxpayer (unless it can fit into "taxpayer was seriously ill").

✓ Funds were stolen from the account; taxpayer was unaware of the theft for some period of time (unless fraud and theft count as "financial institution error").

This does not mean that waivers cannot be granted for those causes. It just means you must use the apply-for-a-private-letter-ruling approach (¶ 2.7.07) rather than self-certification. See Appendix A (Group "B" rulings) for a preview of how your request may fare.

Why did the IRS not include these popular "hardships" in its self-certification procedure? Perhaps the IRS wants to personally review the facts in those situations. For example, the mental or emotional state of the taxpayer can be rather subjective and has a wide range. The IRS will normally grant the waiver if the taxpayer suffered from such mental impairment that he didn't understand the nature of the IRA distribution he took (documented by a doctor's opinion), but will not grant the waiver if the failure was due to the taxpayer's alleged extreme stress caused by getting ready to go on vacation.

2.7.07 ***Hardship waiver, method #2: Apply for IRS PLR***

A. Rev. Proc. 2003-16: Getting your hardship waiver PLR

A participant or surviving spouse who does not qualify for self-certification (¶ 2.7.06) can request a hardship waiver of the rollover deadline from the IRS by following the procedure for obtaining a private letter ruling, as outlined in Rev. Proc. 2003-16.

Obtaining an IRS letter ruling requires payment of a "user fee" (filing fee). Prior to 2016, requests for waiver of the 60-day deadline had their own special reduced user fee schedule, but effective in 2016 and later the user fee is the same as for any other PLR—$10,000 (possibly less for low-income taxpayers).

Since the issuance of Rev. Proc. 2003-16, the IRS has issued hundreds of private letter rulings dealing with these deadline waiver requests. Many of these situations would now qualify to use the self-certification procedure (see ¶ 2.7.06 above). "Appendix A" of this outline collects some PLRs in which the IRS granted or denied hardship waivers of the 60-day rollover deadline, sorted by the nature of the "hardship" that led to the request. Part A covers rulings based on hardships in the menu of 11; Part B covers rulings based on other hardships. Part C provides rulings discussing factors that may impact any hardship waiver claim, such as the amount of time that has passed since the original distribution and whether the money was spent.

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

B. Husband and Wife Get Single Waiver for Both

One feature of marriage is that the spouses can get erroneous advice jointly, or be defrauded in tandem, or both be unable to handle financial affairs when one is seriously ill. The IRS recognizes this by allowing the spouses to apply jointly for a hardship waiver of the 60-day rollover deadline that will cover both of their accounts, thus saving the cost of one IRS "user" (filing) fee. See PLRs 2011-38051 and 2011-17039.

C. 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 (e.g., taxpayer waited until the 58th day, then found the bank was closed for a long holiday weekend so she couldn't deposit the check; PLR 2004-11052).

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 worst thing about the IRS's "evolving" standards is that the IRS is not consistent. The IRS has taken to reciting a 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 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.

In Rev. Proc. 2003-16, the IRS stated that it 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" in deciding whether to grant the waiver.

We have seen over the years the IRS hardening its position that, whereas the factors listed in Rev. Proc. 2003-16 were originally considered illustrative, they became mandatory.

D. Erroneous tax advice

Another IRS 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 NUA treatment (see ¶ 2.5). After the 60-day rollover deadline had passed, he found out the distribution did *not* qualify for NUA 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 2005-05017, 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 but mentions no such additional factors in the other PLRs.

E. Waiver denied: Taxpayer's own mistake

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.

Similarly, a taxpayer who thought she had 60 *business* days rather than 60 *calendar* days to complete the rollover did not get a waiver. PLR 2014-49009. The taxpayer who gave her IRA distribution check to her husband to reinvest without telling him it was an IRA did not get a waiver. PLR 2014-18063. The taxpayer who requested a distribution to himself of his entire qualified plan balance, rather than a direct rollover to an IRA, thereby triggering mandatory income tax withholding (which he was informed about) was not granted a waiver to allow him to wait until he got the taxes refunded to complete rollover of the withheld portion. PLR 2014-19026.

See PLRs 2010-02049, 2010-03030, 2010-06035, 2010-07080, 2010-15039, and 2010-37038 for other examples of this IRS position.

F. What "hardship" means to the IRS; "short term loans"

A case that sounds tragic and heartrending to you and me might not meet the IRS's standards, and yet they might give a waiver to someone else whose story doesn't exactly bring tears to your eyes. That's because the IRS doesn't care about what hardship *may have caused you to withdraw money from your IRA in the first place*. And if you've spent the money that was distributed to you, they don't care about what hardship may have prevented you from collecting replacement funds to complete the rollover. They will grant you a hardship waiver only if you have the money in your hand ready to roll it over and some external factor (such as a natural disaster, illness, or third party mistake) prevents you from completing the rollover on time.

Here's the IRS's idea of hardship: Employee gets erroneous info from his employer, so the employee doesn't roll over enough of the distribution to totally eliminate the income tax, as he intended to do. Waiver granted. See PLR 2011-44040. Or a person thinks the 60-day deadline is measured from the date of the check, not the date of RECEIPT of the check, causing him to miss the deadline. Waiver granted. See PLR 2011-50038.

Now here are three cases where the IRS *refused* to grant a hardship waiver: No hardship here!

In PLR 2011-30014, the participant lost his job and experienced financial difficulties as a result. He withdrew money from his IRA on 2/20/08 because of the financial difficulties, intending to roll the money back IN to the IRA when he received the proceeds from sale of his home or got a new job. But then on 3/6/08 his home burned down so he couldn't sell it. When he got the insurance proceeds from the fire he tried to roll the money back into the IRA on 9/3/08. Waiver denied. Regardless of what financial pickle you are in, you are NOT allowed to use your IRA as a "short term loan!"

In another 2011 PLR, Mother's mobility limitations made it unsafe for her to continue to live in her 2-story residence. So the participant ("P") and his siblings put up the additional money required (along with sale proceeds of the old residence) to buy her a new safer residence. P got his share of the money for this from his IRA, intending to put the money back IN the IRA when mother repaid all the siblings from the proceeds to be received from a "reverse mortgage" on the new residence. But despite repeated assurances, the bank did not manage to complete the reverse mortgage until after the 60-day rollover deadline. Waiver denied.

In PLR 2011-46024, Mother had dementia. She needed to be moved to an assisted living facility. Acting under a durable power of attorney (DPOA), daughter withdrew money from mother's IRA to pay the cost of this transition, intending to replace the money upon sale of mother's existing home. But the home could not be sold fast enough—partly due to market conditions, and partly due to the deteriorated condition of the home (caused by mother's dementia, which made her unable to care for the home). So mother and daughter missed the 60-day deadline. Waiver denied. Daughter "has not alleged that any of the factors enumerated in Rev. Proc. 2003-16 prevented her from timely completing the rollover." Furthermore, daughter "assumed the risk" that she might not recoup the rollover money fast enough through sale of the house.

For the IRS's idea of hardship, see PLRs 2006-06055, 2009-30052, 2009-51044, 2009-52066, and 2010-39041, granting "hardship" waivers to people who waited until the 60th day of the rollover period to complete their rollovers, only to belatedly discover what has been known since the Julian calendar was adopted, namely that the 60th day fell on a weekend or holiday). Now *there's* a situation that tugs at the IRS's heartstrings and brings tears to its eyes!

G. Hardship Waiver Cures SOSEPP Modification?

In PLR 2011-13047, Taxpayer was taking a "series of substantially equal periodic payments" (SOSEPP) from his IRA. Distributions that are part of a SOSEPP are not subject to the 10 percent excise tax on pre-age 59½ distributions under § 72(t). See Chapter 9 of *Life and Death Planning for Retirement Benefits* regarding the § 72(t) excise tax; see ¶ 9.2 regarding the SOSEPP exception. Any "modification" of the series prior to reaching age 59½ (or the fifth anniversary of the start of the series, if later; see ¶ 9.3 of *Life and Death Planning for Retirement Benefits*) disqualifies the SOSEPP and causes the excise tax to be due retroactively on all the SOSEPP payments received prior to age 59½. In this PLR, the IRA provider made a mistake and sent the taxpayer more money than he was supposed to receive under the SOSEPP, then refused to allow him to "roll" the excess payment back into the IRA. The IRS ruled that the IRA provider erred in not allowing the taxpayer

to roll the excess payment back in to the IRA. The IRS did not rule one way or the other regarding whether the accidental excess payment constituted a "modification" of the SOSEPP.

❦3.6 Recharacterization of an IRA Contribution

This section is an abbreviated version of ¶ 5.6 of *Life and Death Planning for Retirement Benefits* (forthcoming 2018 edition), "Recharacterizing an IRA or Roth IRA Contribution."

With limited exceptions, the Code allows a taxpayer who has made "any contribution to an individual retirement plan" during a particular taxable year to move that contribution to "any other individual retirement plan." If the transfer meets certain requirements, the contribution is treated, for all purposes of the income tax code, as if it had been originally made to the second (transferee) IRA. As of 2018, there are only two exceptions to this treatment:

- An IRA contribution that was a valid post-2017 Roth conversion from a traditional plan or IRA cannot be recharacterized. See ❦**3.6**, ¶ 5.6.08.

- The statute allows other exceptions to be created by the IRS, and the IRS has decreed that a tax-free rollover or transfer cannot be recharacterized.

See § 408A(d)(6)(A). The IRS has issued Reg. § 1.408A-5 governing (and limiting) such transfers.

The Code calls these transfers "adjustments." The IRS and this book call them "**recharacterizations**." In certain cases, § 408A(d)(6) may (1) allow a taxpayer to change his mind about his IRA contribution or conversion and/or (2) enables him to fix a mistake.

5.6.01 ***Recharacterization: Introduction and overview***

The most common use of recharacterization, prior to 2018, has been to undo a Roth IRA conversion: A taxpayer who (prior to 2018) converted a traditional IRA or plan distribution to a Roth IRA could reverse that conversion using § 408A(d)(6), thereby avoiding the income tax that otherwise would have been due on the Roth conversion. (Note: "In-plan" conversions could NOT be recharacterized at any time.)

Though much less common, a taxpayer who has made a "regular" IRA or Roth IRA contribution can also use § 408A(d)(6), if he changes his mind about what type of IRA he wants (or is eligible for), to switch the contribution from a traditional to a Roth IRA, or vice versa. Reg. § 1.408A-5, A-10, Examples 2, 3.

Finally, recharacterization can be used to fix mistakes. See ¶ 5.6.09.

Treatment of a transfer as a recharacterization is elective. Reg. § 1.408A-5, A-1(a), (b).

Here are the requirements that must be met to achieve the desired treatment of having the contribution that was originally made to "IRA #1" treated as if it had originally been made to "IRA #2," under § 408A(d)(6) and Reg. § 1.408A-5:

- Not all IRA contributions may be recharacterized. For which may and which may not, see ¶ 5.6.02.

- The movement from the first to the second IRA must be accomplished by "trustee-to-trustee transfer" (§ 408A(d)(6)(A)) and meet certain other "mechanical" requirements; see ¶ 5.6.03.

- Not only the contribution itself but also the "net income attributable to" the contribution must be transferred to the second IRA. See ❦4.2, "How to Compute Earnings on Returned or Recharacterized Contributions."

- Partial recharacterizations are allowed. ¶ 5.6.05.

- The deadlines for IRA contributions, and recharacterizations, are confusing. See ¶ 5.6.06, ¶ 5.6.07.

- See ¶ 5.2.05 regarding the effect of a recharacterization on calculation of the required minimum distribution.

- Recharacterization applies only to *IRA contributions*; it is not and never has been available for in-plan conversions. See ¶ 5.7.03.

5.6.02 ***IRA contributions that may be recharacterized (or not)***

Here are the types of IRA contributions that can be recharacterized:

- A pre-2018 "Roth conversion" (i.e., the contribution 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 pre-2018 Roth conversions and "failed" conversions may be recharacterized. Regs. § 1.408A-4, A-3(a), § 1.408-8, A-8(b). See ❦**3.6**, ¶ 5.6.08, regarding the effective date of this TCJA 2017 ban on recharacterizing Roth conversions.

- A "regular" contribution (¶ 5.4.02) made to either type of IRA (traditional or Roth) for a particular year may be recharacterized as a contribution to the other type. Reg. § 1.408A-5, A-10, Examples 2, 3. This type of recharacterization is not impacted by TCJA 2017.

Though the IRS's example of recharacterizing a "regular" contribution deals with a small annual-type regular contribution, remember that the IRS considers every IRA contribution that does not qualify as a valid "rollover contribution" to be a "regular contribution"—even if the contribution exceeds the annual IRA contribution limit. See, *e.g.*, Reg. § 1.408A-4, A-6(c). Thus, recharacterization should be considered whenever a botched IRA rollover occurs as it may provide a way to fix the problem. See ¶ 5.6.09.

However, not every IRA contribution can be recharacterized. Here are IRA contributions that can NOT be recharacterized:

1. 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), 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 participant (but not a beneficiary) can convert, to a Roth IRA, the traditional IRA he has created via this tax-free rollover; he just cannot make such conversion "retroactive" to the original tax-free rollover from the plan to IRA #1.

2. Similarly, a tax-free transfer or rollover from one traditional IRA into another cannot be recharacterized as a Roth conversion. Reg. § 1.408A-5, A-10, Example 4.

3. 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 the employee may be able to convert the SEP or SIMPLE account to a Roth IRA; see ¶ 5.5.01(A).

4. A recharacterized contribution apparently cannot be recharacterized *again*, because the decision to recharacterize cannot be revoked once the transfer to "IRA #2" has occurred. Reg. § 1.408A-5, A-6(b).

5. Finally, the "Tax Cuts and Jobs Act" (TCJA 2017; P.L. 115-97) amended the § 408A to provide that Roth conversions may not be recharacterized; see ❦**3.6**, ¶ 5.6.08.

5.6.03 ***How to recharacterize an IRA contribution***

A recharacterization requires the following steps:

Step 1: Identify the traditional or Roth IRA account into which the recharacterized contribution is to be moved. Open a new account if necessary. This transferee account ("SECOND IRA") must be one into which the original contribution could legally have been made. Note: Even a pre-2018 Roth conversion that comes from a *nonIRA* plan (¶ 5.5.01(B)) is recharacterized by being moved into *a traditional IRA*, NOT back into the traditional nonIRA plan it was in prior to the Roth conversion. Notice 2008-30, 2008-1 CB 638, A-5, A-7. See PLR 2014-49012.

Step 2: Provide notice of the election, and directions, to the two IRA sponsors involved (or to the single sponsor, if the both the transferor and transferee IRAs are with the same IRA provider), *on or before the date of the transfer*. The notice must state "that the individual has elected to treat the contribution as having been made to the SECOND IRA, instead of the FIRST IRA, for Federal tax purposes" and "must include the following information: the type and amount of the contribution to the FIRST IRA that is to be recharacterized; the date on which the contribution was made to the FIRST IRA and the year for which it was made; a direction to the trustee of the FIRST IRA to transfer, in a trustee-to-trustee transfer, the amount of the contribution and net income allocable to

the contribution to the trustee of the SECOND IRA; and the name of the trustee of the FIRST IRA and the trustee of the SECOND IRA and any additional information needed to make the transfer." Reg. § 1.408A-5, A-6(a), (b).

Step 3: Transfer the contribution that is to be recharacterized, plus (or minus) earnings attributable thereto (¶ 5.6.04) from the IRA it was actually contributed to (FIRST IRA) to the second (transferee) IRA (SECOND IRA) by the applicable deadline (¶ 5.6.07). § 408A(d)(7); Reg. § 1.408A-5, A-1(a). The transfer must be by means of a trustee-to-trustee (plan-to-plan) transfer—it can NOT be accomplished by a "60-day rollover." Reg. § 1.408A-5, A-1(a). See ¶ 2.6.01 for the difference.

Step 4: "An individual who makes this election must report the recharacterization, and must treat the contribution as having been made to the SECOND IRA, instead of the FIRST IRA, on the individual's Federal income tax return for the [applicable] taxable year...in accordance with the applicable Federal tax forms and instructions." Reg. § 1.408A-5, A-6(b). See Instructions to IRS Form 1040, lines 15a and 15b (2016), p. 25, and Form 8606 (2016), "Recharacterizations," p. 4.

Step 5: Post-recharacterization limitation: Once a recharacterization of an amount converted (prior to 2018) 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 could not be used to flip the same dollars back and forth quickly between traditional and Roth IRA status. Reg. § 1.408A-5, A-9.

If the individual defies this rule and attempts to reconvert before the prescribed time period ends, the result is a *failed conversion*.

In effect, this rule bars immediate "reconversions" only for an individual who converted *all* of his traditional IRAs to a Roth IRA. Someone who converted only part of his traditional IRAs can avoid the effect of the rule by simply converting *some other amount* immediately before or after he recharacterizes the first Roth conversion.

A pre-2018 Roth conversion effected by transfer from a nonIRA plan to a Roth IRA can be recharacterized under § 408A(d)(6). Notice 2008-30, 2008-1 CB 638, A-5, A-7. 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. However, the IRS may intend that this ban also applies to plan-to-Roth-IRA conversions, under the rule that plan-to-Roth-IRA conversions are taxed "as if" the money went through a traditional IRA first on its way to the Roth IRA; see ¶ 5.5.04(A).

5.6.04 ***Income allocable to the contribution*** *[omitted; see* ❦4.2]

5.6.05 ***Partial recharacterizations***

Recharacterizations are not an all-or-nothing thing; 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, prior to 2018, 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 ¶ 5.6.04) 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)(6), Example 2.

If an individual (prior to 2018) converted his IRA to *multiple* Roth IRAs, the regulations appeared to permit him to "unconvert" one or more of the multiple Roths without undoing all of them. See Reg. § 1.408A-5, A-1. Thus, prior to 2018, an individual might convert one IRA into several Roth IRAs, with portfolio assets whose values were less likely to move in tandem placed into separate Roth IRAs. That way, if one asset class declined in value prior to the deadline for recharacterizing the account, he could recharacterize just the Roth IRA that held that asset class, and leave the other Roth IRAs alone. Some speculate that "gaming" strategies like this encouraged Congress to ban recharacterization of Roth conversions (which was done by TCJA 2017; see ❦**3.6**, ¶ 5.6.08).

5.6.06 ***Deadline for Roth IRA contributions and conversions*** *[omitted]*

5.6.07 ***Recharacterization deadline: Due date "including extensions"*** *[omitted; see ❦4.1]*

5.6.08 ***TCJA bans recharacterizations of Roth conversions***

TCJA 2017 eliminates the right to undo a Roth IRA conversion. For Roth IRA conversions in 2018 and later, there will be no option to "recharacterize" the conversion; all Roth conversions will be irrevocable.

It is not clear from the statute exactly how TCJA impacts 2017 conversions. Under pre-TCJA law, the 2017 conversion of a traditional plan or IRA to a Roth IRA would have been reversible (i.e., the converter would have been entitled to "recharacterize" it) until October 15, 2018 (assuming the individual timely filed her 2017 income tax return). The provision of TCJA disallowing recharacterization for a Roth IRA conversion contribution "shall apply to taxable years beginning after December 31, 2017." This could be read to mean that the ban applies to *Roth conversions that occur after 2017*—meaning that conversions that occurred *in* tax year 2017 can still be reversed until the 10/15/18 deadline.

But it could also be read as simply banning, after 12/31/17, the recharacterization of *any* Roth conversion, regardless of when such conversion occurred. Under this more pessimistic reading TCJA effectively accelerated the recharacterization deadline for 2017 conversions from 10/15/2018 to 12/31/17. If this reading prevails, it's a bit rough on 2017 converters who reasonably understood and believed, when they did their conversions, that they had until October 15, 2018, to change their minds. It seems likely that few such 2017 converters could have learned of the accelerated deadline in time to act on it.

If it turns out that the "pessimistic" reading is correct, is there any way a 2017 converter can recharacterize in 2018? There is a process under IRS regulations, nicknamed "9100 relief," for

obtaining extension of a tax deadline if various (extensive) requirements are met—but the cost of obtaining such relief on an individual basis starts with a $10,000 filing fee and goes on to include legal fees, delay, etc. See ❦3.7.

Fortunately for 2017 converters, the IRS has adopted the interpretation that the new law applies to *conversions after* 2017, so a 2017 Roth-IRA converter still has until October 15, 2018 to undo that conversion (assuming she files her 2017 tax return on time). The IRS has posted the following statement on its website under Frequently Asked Questions:

> "How does the effective date apply to a Roth IRA conversion made in 2017?
>
> "A Roth IRA conversion made in 2017 may be recharacterized as a contribution to a traditional IRA if the recharacterization is made by October 15, 2018. A Roth IRA conversion made on or after January 1, 2018, cannot be recharacterized."

Find this IRS post at:

https://www.irs.gov/retirement-plans/ira-faqs-recharacterization-of-ira-contributions

The same statement appears in IRS Publication 590-A, "Contributions to Individual Retirement Arrangements (IRAs)," 2017 ed., pp. 2 and 29.

This interpretation makes sense—not only is it fairer for people who relied on the pre-2018 law that applied when they did their conversions, it makes life easier for the IRS since they've already printed up all their tax forms, instructions, and publications for the 2017 year based on the prior law.

Of course, neither an IRS website posting of "FAQs" nor an IRS Publication constitutes legal authority. Some IRA providers may require a more authoritative IRS pronouncement (such as a Revenue Procedure) before processing recharacterizations of 2017 conversions. However, since this reading of the statute appears to be one of the two possible valid interpretations, and it is fairer to taxpayers, and it will probably save the IRS headaches in trying to deal with its already-published forms and publications for 2017 returns, it seems likely this interpretation will prevail.

5.6.09 ***Using § 408A(d)(6) to fix mistakes***

It is clear that (in addition to providing a mechanism for changing your mind about a pre-2018 Roth conversion) a § 408A(d)(6) transfer (recharacterization) can be used to cure certain mistakes. Perhaps it can be used to fix some other mistakes as well.

Here are mistakes known to be "fixable" by recharacterization:

- Recharacterizing a pre-2018 Roth conversion that the would-be converter was not eligible to make is the most common example. Prior to 2010, an income ceiling test applied to Roth conversions. Many individuals who did Roth conversions prior to 2010 actually were not eligible because of this income ceiling, but either did not know about the ceiling, or thought it was higher than it was, or "passed" the test at the time of the conversion but later "flunked"

it due to later-discovered income or adjustments on their tax return due to IRS audit. These individuals had to use § 408A(d)(6) to recharacterize their unlawful Roth conversions. See Reg. § 1.408A-5, A-10, Example 1. In many cases the IRS allowed them to do this even after the deadline; see ¶ 5.6.07(C).

- An employer contribution to a SEP or SIMPLE plan cannot, itself, be converted to Roth IRA status by means of a recharacterization. ¶ 5.6.02. If such a "conversion" is mistakenly done, it can be corrected by recharacterizing the wrongly-transferred amount back into the SEP or SIMPLE. Reg. § 1.408A-5, A-5.

- Any "failed" Roth conversion (*e.g.*, if someone converted an "amount" to a Roth IRA too soon after recharacterizing a conversion of the same "amount"; see ¶ 5.6.08) can be recharacterized. Reg. § 1.408A-4, A-3(a).

- 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. Accordingly, a person who wanted to roll over an IRA distribution to an IRA, but who is barred from doing so by the one-IRA-to-IRA-rollover-per-12-months rule (¶ 2.6.05), can instead roll his distribution into a Roth IRA (Roth conversion), but this would still be taxable. If the sequence occurred prior to 2018, the individual could avoid the income tax hit by then recharacterizing that contribution into a traditional IRA. Reg. § 1.408A-5, A-8.

- SIMPLE IRAs cannot legally receive rollovers or transfers from other IRAs. "...[I]f an amount is erroneously rolled over or transferred from a traditional IRA to a SIMPLE IRA, the contribution can subsequently be recharacterized as a contribution to another traditional IRA." Reg. § 1.408A-5, A-4; PLR 2014-46036. Note that recharacterization in this case does not involve moving money between Roth and traditional IRAs—the transfer is between two traditional retirement accounts.

An intriguing possibility is the use of § 408A(d)(6) when an eligible rollover distribution is mistakenly deposited into the wrong IRA. For example, husband retires and requests a direct rollover to his IRA; by mistake the money is deposited in wife's IRA. Or a Designated Beneficiary requests a direct rollover of an inherited 401(k) plan death benefit (see ¶ 4.2.04); by mistake the rollover lands in the beneficiary's own IRA rather than an inherited IRA. It appears this type of mistake could be "fixable" with a § 408A(d)(6) transfer into the correct IRA, provided the transfer includes the applicable net earnings and is completed by the deadline, so that the contribution is deemed originally made to the transferee (second) IRA.

This application of § 408A(d)(6) has not been reported in any published source. The argument in favor of it is, § 408A(d)(6) says that *any* transfer from one IRA to another (other than a post-2017 Roth conversion; see ❦**3.6**, ¶ 5.6.08), if made within the required time frame and accompanied by its "net earnings," is deemed to have been contributed to the second (transferee) IRA, *except to the extent otherwise provided by the Secretary of the Treasury*. The IRS has not

issued any pronouncement prohibiting § 408A(d)(6) post-death transfers from the beneficiary's own IRA to an inherited IRA. On the contrary, the IRS's regulation says that "an individual" who makes an IRA contribution, and transfers the contribution to a second IRA (within the required time frame and accompanied by earnings) can elect to have the contribution treated as contributed to the second IRA "except as otherwise provided in this section"—and the "section" does not prohibit this type of transfer. Reg. § 1.408A-5, A-1(a).

The IRS's only pronouncement touching near the subject is (in connection with nonspouse beneficiary direct rollovers from a nonIRA plan; ¶ 4.2.04) that "If an amount distributed from a plan is *received by a nonspouse beneficiary*, the distribution is not eligible for rollover." IRS Notice 2007-7, 2007-1 CB 395, A-15; emphasis added. So if the inherited QRP amount is actually sent to the beneficiary's taxable account, the distribution cannot be rolled over. This wording in Notice 2007-7 seems to leave the door open for a § 408A(d)(6) recharacterization/corrective transfer, if the plan distribution *was not* "received by" the nonspouse beneficiary, it was always inside some kind of retirement account—just, temporarily, the wrong type of account.

The argument against this interpretation is that, in another context (purported Roth conversion of a distribution *that was not eligible for rollover*), the IRS treats the improper rollover as a distribution followed by a "regular" contribution of the rollover-ineligible amount to the recipient's own IRA. Reg. § 1.408A-4, A-6(c); see ¶ 5.2.04. If the IRS were to apply the "deemed distribution" rule in the context of the transfer of an inherited plan or IRA benefit to the incorrect type of account, § 408A(d)(6) would not work because the contribution that would need to be recharacterized is the *beneficiary's* "deemed" contribution, not the direct rollover that went from the inherited qualified plan or IRA into the wrong account...and since the beneficiary could not properly have contributed to an inherited IRA, "deeming" his contribution to have gone into that account doesn't help.

However, the IRS has not to date stated that a direct rollover or transfer, into the wrong account, *of an amount that is eligible to be rolled or transferred* is automatically treated as a distribution. On the contrary, the regulation says that a failed Roth conversion is treated as a distribution *only if the improper contribution is not recharacterized*. Reg. § 1.408A-4, A-3(b).

Unlike the situation where the rollover or transfer is proper except for landing in the wrong account, treating the improper conversion *of the RMD amount* as a deemed distribution *helps* the taxpayer (by avoiding imposition of excise tax for failure to take the RMD; ¶ 1.9). Since the taxpayer would have to pay income tax on this "deemed" distribution in any event, he is not harmed by losing out on the rollover he wasn't eligible to make in the first place. But applying that automatic-deemed-non-fixable-distribution rule to a misdirected rollover/transfer *that never leaves the retirement plan environment* would produce harshly unfavorable results for the individual whose legal rollover or transfer merely went to the wrong account.

❦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. To find applicable disaster tax relief, search www.irs.gov for the name of the event (*e.g.*, Hurricane Irma).

For everybody else, there are procedures for applying to the IRS for relief in cases of good faith errors. See Reg. § 301.9100-1 *et seq*.. § 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…." This procedure is nicknamed "9100 relief." If seeking such relief, you need to study the regulations and carry out all the steps required thereby.

Examples of 9100 relief in connection with recharacterizations

9100 relief has been sought and granted extensively in connection with Roth IRA conversions and occasionally in connection with other IRA rollovers or contributions:

In connection with post-death recharacterizations of Roth conversions, see PLRs 2002-19040 and 2002-34074 and ¶ 4.1.02.

In the years 1998–2009, a taxpayer was eligible to convert traditional IRA money to a Roth IRA only if his adjusted gross income (AGI) did not exceed $100,000. See ¶ 5.5.02(E). In numerous PLRs granting late recharacterization, the taxpayer carried out a Roth conversion that he was actually not eligible to make because of this income limit. In most cases the taxpayer's error about the income limit was due to either: erroneous advice from a financial advisor (FA), financial institution (FI), or tax preparer; or subsequent income adjustments the taxpayer did not know of at the time of the conversion; or other understandable source of confusion (which factors also caused the taxpayer to miss the recharacterization deadline). In some rulings, however, the error seems to have entirely the taxpayer's own. Nevertheless, when the original conversion was invalid (failed conversion), the IRS has not denied late recharacterization in any ruling the author has seen to date. See PLRs 2001-16053, 2001-16058, 2001-19059, 2001-20040, 2001-22050, 2001-26040, 2001-28058, 2001-29040, 2001-30058, 2009-09073, 2009-28044, 2009-48065, 2010-04037, 2010-16095, 2014-04016, 2014-04018, 2014-39006, and 2014-42071.

Also, if the taxpayer timely initiated a recharacterization, but it was not completed on time solely due to financial institution error, the IRS (to date) permits late recharacterization. See PLRs 2001-16057, 2008-26040, 2008-50052, 2009-21036, 2014-31038, 2014-49012, and 2014-49013.

If the initial Roth conversion was valid, and the taxpayer did not timely initiate recharacterization, the taxpayer will need to convince the IRS that factors beyond his control caused him to miss the recharacterization deadline—factors such as mental disability (2014-23044) or fraudulent concealment of investment losses (2015-06015). Receiving incorrect professional advice or financial institution information about the tax consequences of the conversion (along with a suitable reason for not knowing of the need to recharacterize by a certain date) can be grounds for late recharacterization; see PLRs 2013-01020, 2013-20022, 2014-48034, 2015-06017, 2016-03047. Similarly, 9100 relief can be granted if the need for late recharacterization is caused by any other mistake or omission by a financial advisor, financial institution, or tax professional; see PLRs 2014-27025, 2014-39006, 2016-17019, 2016-27008.

However, if the IRS believes the late recharacterization is sought due to "hindsight" (Roth investments declined in value), and the taxpayer can not pin most of the blame for lateness on

someone other than himself (even if there are other parties who contributed to it), the IRS will not grant 9100 relief. See PLRs 2010-24071, 2016-35013.

For late recharacterization allowed in connection with regular Roth IRA contributions (as opposed to conversions) see PLRs 2015-11022, 2016-03048; in connection with improper rollover from traditional IRA to SIMPLE, see 2014-46036.

How to apply 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. See the "Additional Checklist for Roth IRA Recharacterization Ruling Requests" in Appendix C of Rev. Proc. 2016-4, IRB 2016-1 (1/4/16).

At one time, these requests were subject to their own special reduced "user fee" of $4,000; see, *e.g.*, Rev. Proc. 2012-18, 2012-1 IRB 235 (1/2/12), § 6.01(9). Now, however, these requests have become subject to the "general" letter ruling request user fee (generally $10,000). See Rev. Proc. 2016-4, § 2.02(3) and § 6.01(4).

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.

❦3.8 Getting out from under the Excise tax for Missed RMD

Once it is determined that the 50 percent excise tax 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 generally 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. See ¶ 1.5.03(C) of *Life and Death Planning for Retirement Benefits* (7th ed. 2011). 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 excise tax 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 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 an excise tax, because (except in the year of death itself), the election is effective retroactively to the beginning of the year. Reg. § 1.408-8, A-5(a), fourth sentence.

Ty Example: Ty's wife died in Year 1, at age 72, leaving her IRA to Ty as sole beneficiary. Ty (age 68) should have started taking RMDs in Year 2, the year after his wife's death, in annual instalments over Ty'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 Year 2. Now he meets with you, in Year 3. Does he owe excise tax for failure to take that Year 2 RMD? No. Because of Reg. § 1.408-8, A-5(b)(1), Ty, by failing to take the RMD in Year 2, was deemed to have made an election to treat the IRA as his own IRA. The deemed election was retroactive to the beginning of Year 2. If the IRA is treated as Ty's own IRA for Year 2, then he did not have to take any RMD in Year 2, because he had not yet reached age 70½.

C. Request waiver of the excise tax: Road Map

The above are uncommon ways to avoid the excise tax, applicable in unusual circumstances. The more often used way to negate the excise tax is to request a waiver from the IRS. The excise tax 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-B (*Distributions from IRAs*), 2015, p. 27.

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

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 excise tax:

1. File one form 5329 for each year in which the client missed taking an RMD. For example, if it is now 2016, and the client failed to take his RMD in the years 2013 and 2014, you will file one form 5329 for 2013 and one for 2014. 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.

   Exception: For the participant's first distribution year, the deadline for taking the distribution is April 1 of the following year (the "required beginning date" (RBD); § 401(a)(9)(C); § 408(a)(6); Reg. § 1.408-8, A-3; see ¶ 1.4.01 of *Life and Death Planning for Retirement Benefits*). If the participant misses that deadline, and he seeks waiver of the penalty, he files Form 5329 *for the year in which the RBD falls*, not the actual "distribution year." See Instructions for IRS Form 5329 (2017), p. 8, "The tax is due for the tax year that includes the last day by which the minimum required distribution must be taken." Example: Pat turned age 70½ in 2015. 2015 was her first "distribution year" for her IRA. She was supposed to take the RMD for 2015 no later than April 1, 2016, but she missed the deadline. To report that missed RMD to the IRS and request the waiver, she will file Form 5329 *for 2016*, even though the "distribution year" was 2015.

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 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.

4. 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 excise tax! If you put any dollar amount on this line, the IRS will assess the excise tax and start sending you dunning notices.

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

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

6. Recommended: 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. What constitutes "reasonable error?"

There are no IRS pronouncements other than, to date, one PLR regarding the standards used in determining whether there was "reasonable error." Unlike rulings granting the hardship waiver of the 60-day rollover deadline, requests for waiver of the 50% excise tax are filed and granted (or denied) privately, without publication of the IRS's decision. Here is the one known exception:

Two rulings involving the same fact situation discuss several interesting questions. Participant died 1/20/2006 at age 77, leaving his IRA partly to his longtime friend "B," and partly to his medical care provider "D." Friend B and the participant's ex-wife C brought a court case challenging the designation of care provider D. Assets of the IRAs were frozen pending the outcome of the litigation and it was not possible for B and C (who ultimately prevailed) to take RMDs until the case was settled June 16, 2010.

C (in PLR 2014-37025) and B (in PLR 2014-37034) asked, first, that they be allowed to delay the start of RMDs until the settlement date. This request was apparently denied. They then asked for a waiver of the 50% excise tax for failure to take the RMD for the years prior to the settlement agreement. This was granted, because the ongoing litigation and dispute about who was entitled to the account constituted reasonable cause for failure to take the RMDs, and because the taxpayers would take the "shortfall" by the end of 2014.

Finally, the IRS ruled that the caregiver-D's life expectancy was the Applicable Distribution Period because she was the beneficiary as of the date of death and had not disclaimed prior to the Beneficiary Finalization Date. There is no mention of the relative ages of B, C, and D.

E. How to "remedy the shortfall"

The IRS has not issued specific guidance on how to "remedy the shortfall" with respect to a missed RMD from an IRA. Here are two suggestions.

One approach is to determine the correct RMD for each year in which there was a shortfall by simply dividing the prior year's actual year-end account balance by the applicable factor for the distribution year you are working on—with no adjustments. The author has used this simple method in one uncomplicated case involving small missed distributions from a large IRA balance and had the waiver request granted.

A more elaborate method that presumably has IRS blessing adjusts each missed RMD in two ways: First the RMD itself is adjusted to reflect the fact that the money that should have been distributed has grown [or possibly shrunk] as a result of investment performance inside the plan. Thus, the "shortfall" amount will be the amount of the missed distribution plus or minus earnings that have "accrued" on that money while it ("wrongfully") remained inside the plan. Second, instead of using the actual prior year-end account balances to compute the RMD, the prior year-end account balance is reduced by the amount of any RMD that should have been but wasn't distributed before such year-end. Whether this approach produces a result substantially different from the simple method I don't know.

Here's where the more complicated method comes from. In the arena of qualified retirement plans, the IRS has various "voluntary compliance" and "self-correction" programs to enable plan administrators to correct operational errors that have occurred. The IRS issues a Revenue Procedure,

usually updated about every two years, explaining how to correct various retirement plan mistakes to satisfy the voluntary compliance/self-correction program. The most recent edition is Rev. Proc. 2018-52, 2018-42 IRB 611, which provides as follows in "Appendix A, Operational Failures And Correction Methods," at paragraph .06:

"**.06 Failure to timely pay the minimum distribution required under § 401(a)(9).** In a defined contribution plan, the permitted correction method is to distribute the required minimum distributions (with Earnings from the date of the failure to the date of the distribution). The amount required to be distributed for each year in which the initial failure occurred should be determined by dividing the adjusted account balance on the applicable valuation date by the applicable distribution period. For this purpose, adjusted account balance means the actual account balance, determined in accordance with § 1.401(a)(9)-5, Q&A-3, reduced by the amount of the total missed minimum distributions for prior years....."

The Rev. Proc. explains that "the Earnings rate generally is based on the investment results that would have applied to the [amount] if the" mistake had not occurred. Appendix B, Section 3.01(3)(a). Section 3 also contains examples of these calculations. The goal is to approximate the amount of investment income (or losses as the case may be) that accrued to the missed RMD amount during the period of time it remained inside the retirement account when it should not have been in there.

F. Request waiver of the excise tax: Example

John is your new client. He is age 85. His tax preparer 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 tax preparer 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.

G. Waiver of the excise tax: Ask the "gurus"

Sometimes I get an IRA question I don't know the answer to. That's when I turn to my nationwide circle of IRA experts. I call them the "IRA gurus." With their astounding collective experience and knowledge, they can often help. So keep those questions coming!

Question: Our client's father, "Homer," is in his 90's. Since he was 70½, he had his IRA minimum distributions sent to him by monthly automatic transfer into his bank account. This had been arranged for him each year by his IRA provider. Last year he moved closer to his son's (our client's) home due to some serious health problems, and in the process moved his IRA to a different provider. However, he neglected to reinstate the automatic sending of the required distributions. His health issues contributed to a declining ability to manage his affairs. As a result he failed to take the required distributions for the year 2010. Homer's son helped him with his 2010 tax return, and had him file "Form 5329" as part of the return, reporting the missed distribution and requesting a waiver of the 50 percent excise tax. Now, the IRS has just sent him a notice that the excise tax is due—with no mention of the waiver request. Is there anything Homer can do at this point to avoid that tax?

Answer: I don't have experience with this situation so I turned to my IRA gurus. These enormously knowledgeable and productive people manage to not only speak and write about retirement benefits, they also actively consult with, advise, and/or represent clients who have retirement benefit issues with the IRS. They had plenty of practical suggestions for Homer:

Barry Picker, CPA, of Brooklyn, NY, author of *Barry Picker's Guide to Retirement Distribution Planning*, speaks nationally and actively practices in the retirement benefits tax area. He says, "The IRS response sounds like a computer generated notice caused by the filing of the 5329. I've had this before. Don't pay; respond with a letter to the address on the notice explaining the situation and requesting the waiver. Chances are good you'll succeed."

Bob Keebler, CPA, of Green Bay, WI, nationally known speaker and author of multiple publications dealing with the tax treatment of IRAs and Roth IRAs, heads his own accounting firm that specializes in helping individuals solve their IRA vs. IRS problems. Bob has drafted over 150

successful IRS private letter ruling requests in the retirement benefits area. He was succinct: "I agree with Barry!"

Denise Appleby, author of the invaluable "Appleby IRA Quick Reference Guides," reminds the questioner that, "It's not enough to explain why you missed taking the required minimum distribution. You also must 'take steps to remedy the shortfall,' meaning that Homer must take the 2010 distribution now, in 2011, before asking the IRS to waive the excise tax. Both steps are required before the IRS will consider granting a waiver."

Ed Slott, CPA, publisher of the terrific *Ed Slott's IRA Advisor* newsletter, who trains financial advisors how to use retirement benefits expertise to grow their practices, agreed with all of the above: "I would have originally advised him to take the missed 2010 distribution immediately and file the 5329 not only asking for the waiver of the excise tax, but also showing that he made up the missed distribution - that he took immediate corrective action upon discovering the error. Also state the reason for the oversight which in this case is logical and I believe would warrant a waiver of the excise tax. But now he has an IRS notice which must be answered. I would respond that the missed distribution was made up, state the reason for the honest oversight, and ask for the excise tax to be abated and it should be. In addition, mention that before this, he had a perfect track record of never missing a required distribution because they were withdrawn automatically. Once IRS puts this all together, the excise tax should be waived and he should be fine...but it might take a few letters to get this resolved."

Seymour "Sy" Goldberg, Esq., CPA, well known speaker and author on the tax treatment of retirement benefits, also tangles regularly with the IRS on behalf of clients. His comment: "The approach I use with respect to a penalty case in general is to respond to the IRS computer generated penalty notice several times and if that does not resolve the penalty issue, then I request an appeal to the local IRS Appeals Office. Based on the facts of this case, the penalty should be waived at either the IRS Service Center or the IRS Appeals Office."

Mike Jones, CPA, of Monterey, California, speaker, writer, and practitioner, and chair of the editorial advisory board for retirement benefits for *Trusts and Estates* magazine, concurs that if all else fails Homer can "Exercise the right to go to IRS appeals with this. If that doesn't work, a suit for abuse of discretion could be needed; such suits are authorized by statute. Given the taxpayer's long history of compliance, it could be an abuse of the IRS's discretion not to waive the penalty."

I am a big fan of my IRA gurus. If they don't know the answer, there is no answer!

Resources: To get acquainted with the gurus, start by visiting their websites: For Barry Picker, go to http://www.pwacpa.com/pickerbio.html. Bob Keebler's website is http://www.keeblerandassociates.com/about. To learn more about Denise Appleby or order her newsletter or Quick Reference Guides, visit http://www.applebyconsultinginc.com/. Mike Jones hangs out at http://www.thompsonjones.com/mikejones.html. To access Ed Slott's information trove or subscribe to the *IRA Advisor*, go to http://www.irahelp.com/. To enlist the help of Sy Goldberg, start at http://www.goldbergreports.com/.

❦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.

I think I will have to stop using the words "always" and "never" in discussing the rules applicable to retirement benefits. Here's an example of some words I may have to eat. The following comes from ¶ 4.2.02(A) of *Life and Death Planning for Retirement Benefits*:

"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'...A nonspouse beneficiary's taking a distribution from an inherited plan, even if accidental or unintentional, is a mistake that cannot be fixed; *the IRS simply does not have the power to authorize the recontribution of the distributed amount to the same or another plan*. *See PLR 2005-13032."*

PLR 2011-39011 disproved the above statement. In this PLR, father died leaving his qualified retirement plan benefits to his minor child, "Taxpayer A." Taxpayer A's mother, Individual F, was appointed as guardian of the child. The retirement plan benefit, because it was in a qualified retirement plan, and because the decedent died in 2008, was eligible for a "nonspouse beneficiary rollover." Instead of arranging such a transfer, however, the mother-guardian requested a lump sum distribution on the child's behalf. The distribution was reported on the child's 2008 income tax return and she paid tax on it.

Apparently, the mother misused some or all of the child's funds. A new conservator was appointed for the child, who obtained a court order compelling the mother to pay back the misappropriated funds. Since "But for the decision by [the mother/guardian] to receive a lump sum distribution...*and her subsequent misuse of the funds*" [emphasis added] a tax-free transfer "could have been made to an inherited IRA," the IRS ruled that the funds could NOW be transferred into an inherited IRA, and the child's income tax return for 2008 could be amended to erase the reported lump sum distribution!

Say what???? This is the first instance I have ever heard of permitting in effect a "late rollover" of a distribution that was not eligible for a 60-day rollover to begin with. The IRS doesn't mention the 60-day deadline hardship waiver procedure for good reason—the distribution wasn't eligible for a 60-day rollover, so there is no "deadline" to be waived.

And what did the mother's "subsequent misuse" of the funds have to do with it? It was the mother's *request for a lump sum distribution* that eliminated the possibility of a "direct trustee-to-trustee transfer." A direct trustee-to-trustee transfer is the opposite of a 60-day rollover. If the mother had requested the lump sum distribution but not misused the funds, would the IRS not have granted the favorable ruling regarding returning the money?

The IRS may have reason to regret this ruling in the future. There are numerous cases every day in which nonspouse beneficiaries request (or receive without requesting) distributions of inherited plan benefits which they later wish had not been distributed. Sometimes this happens because the beneficiary is unaware of his options for continued deferral of the funds, and when he later becomes aware he regrets taking out the money. Sometimes plans and IRAs distribute funds to beneficiaries before the beneficiary has even requested the funds. In many of these cases the beneficiaries would dearly like to put the money back IN to a retirement plan and get a second chance. Will all those beneficiaries now be encouraged by PLR 2011-39011 to try and reverse the distribution?

Though not articulated in the ruling, this ruling may be primarily based on the notion that the money was in effect "stolen" by the child's guardian, and therefore a more extreme remedy is appropriate (i.e., putting money back into a retirement plan without any statutory or regulatory basis for doing so) than would be permitted in routine cases of mistaken distributions or poor financial advice. I would classify this ruling in the "stolen funds" category, and not regard it as helpful for typical cases of mistaken post-death distributions.

❦3.10 Dealing with a plan overpayment

What happens when a QRP overpays a retiring employee?
The following is based on IRS rulings in IRS Chief Counsel Advice 2013-13015.

Please file form 5329 every year!

The sad result in CCA 2013-13015 could have been partially mitigated had the taxpayer filed Form 5329 every year. See ❦3.11 for discussion of why every IRA owner should file Form 5329 every year!

Question: In Year 1, Company X has two employees who are retiring, A and B, both age 65. The plan administrator has a bad hangover, mixes up the two accounts, and pays A $125,000, which was the amount B was supposed to receive, and pays B $150,000 which was actually the amount of A's benefit. So A has received less than she was supposed to receive, while B got an overpayment. Nobody notices this mistake until Year 3, at which time the plan immediately notifies the two retirees and starts trying to straighten out the mess.

Everyone agrees there was no way the employees could have spotted this error, short of hiring a forensic accountant to scrutinize several years' worth of plan documents.

Which retiree has bigger problems, A or B?

Answer: That's easy—B is in big trouble, while A is on easy street.

A got less than she was entitled to. So for two years she thought she wasn't as well off as she actually was, and that of course is unfortunate, but to make up for it she'll get a nice fat check for the difference. She can spend that or save it, and have some good laughs with her friends about the stupid mistake her former employer made.

B on the other hand has problems...big problems. Just on a psychological level, she is poorer than she thought she was, and so unlike A (who receives an unexpected windfall), B has to suddenly tighten her belt. Any spending or other financial commitments she made on the basis of this unrealistic belief are strictly her problem—she must repay all that money to the plan regardless.

A plan overpayment followed by a repayment also raises many tax questions. The answer to each question is, "you lose!"

Question #1: Does B have to include the full $150,000 in her gross income for Year 1? After all, she was only entitled to $125,000, so why should she have to include in her income money she had no right to receive?

Answer: The full payment is includible in the employee's gross income. The Code section that decrees taxability of retirement plan distributions has no exception for mistaken payments.

Question #2: When B received that $150,000 payment in Year 1, she rolled it all over to her IRA. Is the $150,000 in fact tax-free in Year 1 because of the rollover?

Answer: No. Rolling over a plan distribution normally does make the distribution not includible in income, but that only applies to "eligible rollover distributions." To be an eligible rollover distribution, the distribution must comprise benefits the individual is entitled to under the plan. Any other plan distribution is not eligible for rollover. So B's rollover in Year 1 did eliminate "includability" for the $125,000 portion of the distribution that she was rightfully entitled to under the plan, but the $25,000 mistaken distribution was not a plan benefit and was not eligible for rollover. So the $25,000 is still includible in income for Year 1. Since she in effect under reported her gross income for Year 1 she will owe penalties for late payment of tax. By the way it's a good thing she's over age 59½; otherwise she'd also owe the 10 percent "premature distributions" excise tax on that $25,000.

Question #3: At the time of the distribution in Year 1, B had already made her maximum "regular" IRA contribution for Year 1, so the $25,000 rollover-that-didn't-qualify-as-a-rollover was actually an excess IRA contribution. B was not eligible to make a "regular" IRA contribution in Year 2, because she was fully retired. She did not take any distributions from the IRA in Years 1 or 2. Does B owe excise tax for the excess IRA contribution in Years 1 and 2? Is there any way to get the IRS to waive this?

Answer: B owes the six percent excess IRA contribution excise tax ($1,500) for Years 1 and 2 on the $25,000 excess contribution (total excise tax $3,000). Unlike with the excise tax for failure to take a minimum distribution, there is no procedure for IRS waiver of the excess IRA contribution excise tax. She does not owe the excise tax for Year 3 because she withdrew the excess contribution fully by the end of Year 3.

Question #4: Is the $25,000 IRA distribution taxable to B in Year 3? It seems like this distribution should be tax-free since she will be required to include the $25,000 in her income retroactively for Year 1.

Answer: Yes it is also taxable in Year 3! It is taxable the same as any other IRA distribution, that is to say, it is fully includible in gross income except to the extent it represents a return of the participant's after-tax "investment in the contract" in the account. Her $25,000 excess contribution to the IRA in Year 1 did create basis in the account, so she gets some credit for it when she computes how much of the Year 3 distribution is includible in her income. However, she can't offset her "basis" dollar for dollar against the distribution. The basis in her IRA is allocated pro rata between the amount distributed and the amount still in the account ("cream in the coffee rule"). So for example if the total IRA value on the applicable date is $250,000, of which $25,000 is her "after-tax contribution," 10 percent of the distribution would be deemed a tax-free return of basis.

Question #5: Does she at least get a tax deduction for the $25,000 repayment she has to make to the plan?

Answer: Oh yes, of course! The IRS regards a repayment of overpaid benefits as a "loss incurred in the trade or business of being an employee," deductible as a miscellaneous itemized deduction under IRC § 165(a), or repayment of a "claim of right." See Repayments in IRS Publication 525 for more information.

Moral for planners: When advising an employee who is retiring, be zealous in making sure she receives everything she is entitled to. Be even more zealous in assuring she does not receive MORE than she is entitled to! Any retiring employee or beneficiary receiving a plan distribution should have an actuary or other professional on her side, someone who can evaluate whether the plan is paying the employee or beneficiary the correct amount. Since plan payment formulas and options are often opaque (especially with a defined benefit plan), this type of review could be extremely valuable to the client...not just to make sure she gets everything she is entitled to, but also to make sure the plan does not pay her too MUCH money!

❦3.11 Procedural matters

A. Statute of limitations for IRA "penalties"

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). See "B" for what return you must file to start the statute running. But even if you do file a return, § 6501(e)(3) provides that a *six-year* statute of limitations applies to Subtitle D taxes (which would include the 50% tax for a missed RMD) "if the return omits an amount of such tax properly includible thereon which exceeds 25 percent of the amount of such tax reported thereon." See "C" below.

The goal of participants and beneficiaries should be to assure themselves the protection of at least the six-year statute of limitations with respect to assessment of the 50 percent excise tax for missed RMDs under § 4974. This can be accomplished by filing Form 5329 every year, even when no excise tax is owed.

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

The excise tax 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.", would be sufficient to start the statute of limitations running. However, in the case of the 50 percent excise tax, the "return" is

Form 5329 according to Reg. § 301.6501(e)-1(c)(4); Instructions for IRS Form 5329 (2016), p. 1; and *Robert K. Paschall et ux. v. Comm'r,* 137 T.C. 8 (7/5/11).

Form 5329 is the return that is filed to report *all* penalties people owe on their IRAs; it also covers the six percent excise tax for excess contributions and the 10 percent excise tax for distributions prior to age 59½. You can file it as an attachment to your income tax return (Form 1040) or as a stand-alone return. The trouble is, nobody ever used to file this return if they didn't think they owed any penalties. But if the IRS later decides you DO owe excise tax, they can go after you for that excise tax literally forever if you didn't file Form 5329 for the year in question.

Why Every IRA Owner Should File Form 5329 Every Year

In the *Paschall* case, the taxpayer had done an improper Roth conversion of a $ 1.2 million IRA about 10 years before the year the IRS caught up with him. He didn't even report the conversion on his income tax return. Since his Roth conversion was improper (he wasn't eligible to do the conversion, because his income was too high), the "conversion" was actually a taxable distribution from his traditional IRA. He should have paid income tax on the entire IRA value. But it was too late for the IRS to go after him for that unreported income, because he had filed an income tax return for that year and now (10 years later) that year was "closed."

However, the IRS had another arrow in its quiver. They treated the rollover to the Roth IRA as an excess IRA contribution, subject to a six percent excise tax *annually* until the excess contribution was removed from the account. Thus the IRS was entitled to six percent times $1.2 million times 10 years. The taxpayer tried to argue the statute of limitations had run on that too, at least as to the early years, but the Tax Court agreed with the IRS: There was no statute of limitations protection because the taxpayer had not filed a Form 5329!

The IRS has used or tried to use this excess-contributions excise tax attack in other cases where it is too late for them to collect additional income taxes. See *Mazzei, et al.,* TC Memo 2014-55. If no 5329 was ever filed, EVERY year is an open year for penalties.

You're absolutely sure you don't owe any penalties? Remember IRS Chief Counsel Advice 2013-13025, where the lady was paid more than she was entitled to receive upon retirement and rolled over this payment to an IRA? She was ruled to have made an excess IRA contribution because she was not entitled to roll over an erroneous payment. And she owed the excess contributions excise tax even though she had absolutely no idea that the company retirement plan had overpaid her!

Since *Paschall*, it has become imperative for prudent IRA owners to file Form 5329 every year, even when they (think they) owe no penalties. If you just file Form 5329, even if you report "zero, zero, zero" in each excise tax section, you start the statute of limitations running. If you report zero and the IRS later assesses some excise tax, then of necessity the amount of the excise tax you "omitted" to report is more than 25 percent of the excise tax, so you get a six-year statute of limitations. You can shorten this to three years by attaching to the return a statement that is "adequate to apprise the Secretary of the existence and nature of such item." Presumably this means a statement of the facts on which you base your conclusion that you do not owe excise tax.

C. 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 tax) "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" excise tax 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 consider filing Form 5329 every year, even when they believe they owe no excise tax, 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.

D. Taxpayer has burden of proof regarding IRA mistakes

The case of ***El v. Comm'r***, 144 T.C. 9 (3/12/15), held that YOU, the IRA owner (or plan participant) have the burden of proof if the IRS asserts"additional taxes" (what are popularly called "penalties") by virtue of your retirement plan activities.

Distributions from retirement plans are generally includible in gross income. There is an exception for a loan to the employee from the qualified retirement plan (QRP) if the loan meets the requirements of § 72(p)(2)(A)(ii). A qualifying loan is treated as a loan rather than a taxable distribution. One of the requirements of the Code section on plan loans is that the total amount loaned to the employee may not exceed the greater of $10,000 or one-half of the employee's vested balance in the plan. [It also may not exceed $50,000, even if the vested balance exceeds $100,000, but that limit was not involved in this case.] If the plan loan exceeds the permitted amount, the excess is treated as a distribution not a loan.

Mr. El took a loan from his employer's QRP in 2009. The amount of his total loans from the plan following this loan was $12,802, which was more than half of his plan balance ($17,017/2 = $8,535.50) and more than $10,000. Therefore the IRS treated the excess ($2,802) as an income-taxable distribution and also assessed the 10 percent additional tax under § 72(t) (sometimes

nicknamed the "premature distributions penalty") due on distributions made prior to age 59½ not otherwise excepted.

One issue in the case was who had the burden of establishing the initial facts with respect to § 72(t). Normally the burden of proof in tax cases starts with the taxpayer. He must present some evidence in support of his position. Once the taxpayer presents "credible evidence" on a factual issue, the burden of proof shifts to the IRS with respect to that issue. § 7491(a)(1), General Rule.

However, a different rule applies to *penalties*. Specifically, "Notwithstanding any other provision of this title," the IRS has the "burden of production" regarding any "penalty, addition to tax, or additional amount imposed by this title." § 7491(c). In other words, when dealing with a penalty, the IRS has to produce evidence to start the process–they can't just assert the penalty then sit back and demand the taxpayer prove the penalty doesn't apply.

So who had the burden of proof regarding the § 72(t) 10 percent assessment against Mr. El, the tax that is often referred to as "the 10 percent penalty" on pre-age 59½ distributions?

The Tax Court considered this subject at length after asking the parties for supplemental briefs on the point. The Court concluded that ***the taxpayer had the burden of proof with respect to the 10 percent tax***. The Court stated that the tax is consistently called an "additional tax" or a "tax," never a "penalty, addition to tax, or additional amount." Therefore Mr. El, not the IRS, had the initial burden to present credible evidence on whether § 72(t) applied.

The IRS sought an alternative ruling: If the Court had held that the 10 percent § 72(t) tax was a penalty, the IRS wanted it to rule that, nevertheless, the taxpayer would have the initial burden of evidence with respect to any *exception* the taxpayer claimed with respect to such penalty. The Court didn't need to get to that question since it did not rule that the tax was a "penalty."

This ruling (which was cited favorably in another Tax Court case a few days later, *McKnight v. Comm'r*, T.C. Memo 2015-47 (3/16/15)) reminds us that on every retirement plan issue I can think of *the taxpayer has the initial burden of proof.* If every "excise tax" and "addition to tax" is, like the 10 percent tax under § 72(t), just an *additional tax* and not an *addition to tax* or a penalty, the taxpayer therefore will have the initial burden on:

- ♦ Whether a plan distribution occurred.
- ♦ Whether a "deemed distribution" has occurred from a retirement plan by virtue of such events as an improper loan (as in *El*) or (in the case of an IRA) a prohibited transaction between the IRA and its owner.
- ♦ Whether a distribution is subject to the "additional 10 percent tax" under § 72(t) for pre-age 59½ distributions.
- ♦ Whether the taxpayer is liable for the six percent penalty, excuse me, *additional tax* for making an excess contribution to his IRA. § 4973(a).
- ♦ Whether the taxpayer is liable for the 50 percent penalty, excuse me, *additional tax* for failure to take a required minimum distribution. § 4974.

❦3.12 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 regular contribution 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 pre-2018 conversion contribution 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 excise tax-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)):

Net Income equals =

$$\text{Contribution} \times \frac{\text{Adjusted Closing Balance} - \text{Adjusted Opening Balance}}{\text{Adjusted Opening Balance}}$$

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 the distributee's gross income if the distribution is "rolled over" to the same or a different "eligible" retirement plan or IRA—provided various requirements are met. § 402(c)(1), § 408(d)(3). If the **rollover** meets all the requirements, but the distribution came from a traditional plan or account and 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.

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)).

Appendix A
The Hardship Waiver PLRs Report

If you are applying for a hardship waiver of the 60-day rollover deadline (❦2.6), or proposing to "self-certify" for such a waiver (❦2.7), you will want to know which fact scenarios, excuses, and theories justify such a waiver—and which do not.

Since 2001, the IRS has issued hundreds of private letter rulings (PLRs) granting (or sometimes denying) these waivers. The goal of this Appendix A is to collect some of those PLRs, sorted by the type of "hardship" the taxpayer claimed caused him or her to miss the rollover deadline. The hope is that this will help the advisor more quickly determine whether his or her client does or does not qualify for self-certification, or (if not) would be likely to receive an IRS waiver if sought through the private letter ruling process.

The IRS has issued a list of 11 hardships that enable the taxpayer to self-certify for the waiver Part A reviews PLRs that were granted or denied based on "hardships" included in the list of 11 reasons for which the self-certification procedure can be used; see ¶ 2.7.06. Presumably, now that self-certification is allowed, there will be few or no more rulings issued by the IRS on these grounds. Study the PLRs in Part A to discern whether your client does or does not qualify for self-certification.

Part B of this Appendix reviews PLRs granted or denied based on hardships that are not included in the menu of 11. The rulings summarized here should give the advisor a good idea of whether his/her client is likely to get a waiver if he/she applies for one using Rev. Proc. 2003-16.

Finally, Part C reviews particular factors that tend to support or undermine a hardship waiver claim, such as whether the distribution money was spent.

Unfortunately, time constraints have caused Appendix A to be left incomplete. Though it covers many rulings on many topics over a long period of time, it also leaves out many. It is hoped it will be helpful to many advisors, even in its incomplete state....to be continued at a later date!

A. WAIVER REQUESTS BASED ON THE 11 REASONS

Here are examples of PLRs that were issued by the IRS (under Rev. Proc. 2003-16; see "B") for one or more of the "11 reasons" listed in Rev. Proc. 2016-47, 2016-37 IRB 346 (¶ 2.7.06). If claiming self-certification under Rev. Proc. 2016-47, consider these PLRs as illustrating what the IRS does and does not consider to be the type of waiver-justifying hardships it has listed in Rev. Proc. 2016-47.

1. An error was committed by the financial institution receiving the contribution or making the distribution to which the contribution relates.

Financial institution (FI) error is by far the most common reason for obtaining a deadline waiver. If your facts resemble the facts in (most of) the following PLRs, then you qualify for the self-certification procedure. When the rollover involves a distribution from an employer plan, I have treated the employer itself as the "financial institution" making the distribution. See, *e.g.*, PLR 2011-44040.

There are three groups of rulings here based on the type of alleged financial institution error:

(a) The FI made a **processing error**, such as failing to follow the taxpayer's instructions.

(b) The FI gave the IRA owner **erroneous information or advice**. If the erroneous advice came from a source *other than* the distributing or receiving FI, see Part (B)(2) instead.

(c) The FI gave the taxpayer **NO information or advice**. In this case there is an "FI error" ONLY if the FI was legally obligated to provide the taxpayer with such information or advice. In several of the PLRs in this group the waiver was denied because there was no such obligation.

(a) Financial institution error—processing error

The PLRs collected here involve a clerical or processing error made by one of the financial institutions. The most routine waiver situation is this: Taxpayer takes a distribution and sends the money to his FI with instructions for the money to be placed in a rollover IRA. Instead, the FI deposits the money in a taxable account and Taxpayer does not discover the error until after the 60-day deadline. See, *e.g.*, PLRs **2004-01023, 2004-02028, 2004-04053, 2004-20035, 2009-51040, 2010-14073, 2011-29046**, and **2011-31035**,.

The "good" news is that the IRS *always* grants the waiver when the participant missed the deadline due to a processing error by an FI. The bad news is, in almost every one of these rulings the taxpayer would not have missed the 60-day deadline if he had timely reviewed the paperwork (or online activity) involved in the rollover transaction. The taxpayer who carefully reviews all transactions in his account, as they occur, can normally catch and fix errors before the 60-day rollover deadline occurs.

Note: It's not enough just to assert "financial institution error;" you have to prove it. In most of the examples of favorable rulings, there were big obvious financial institution goofs, and the institutions admitted their mistakes. If you don't have that kind of evidence you may not be entitled to the self-certification waiver. See, *e.g.*, **PLR 2014-32020** (at "(c)" below).

2012-46044. The participant had many accounts at the financial institution including apparently an inherited IRA account and two regular IRA accounts. The inherited IRA was mistakenly not titled as an inherited IRA, however. The participant instructed the FI to transfer funds ("Amount D") from his regular IRAs into the inherited IRA (which neither he nor the FI seemed to realize was an inherited IRA, since it was not so titled), and the FI did the transfer. The ruling refers to this as a "failed rollover" since funds cannot be rolled from the participant's own IRA into an inherited IRA. Since that was not a permitted rollover, the taxpayer had to remove that erroneous contribution from the inherited IRA and (with permission from the IRS, which he received) do a late rollover of "Amount D" into a regular traditional IRA in his own name. Note that any earnings that had accrued on "Amount D" were apparently allowed to remain in the inherited IRA; if this had been handled as the late recharacterization of an IRA contribution (see ❦3.6, ¶ 5.6.09) rather than as a late rollover the earnings would have followed the IRA contribution back into the participant's own IRA. This ruling should not be considered an example of the IRS allowing the rollover of a distribution from

an inherited IRA (distributions from an inherited IRA are not eligible for rollover except by the surviving spouse), since the distribution that was being late-rolled was the original distribution from the participant's own IRA, not from an inherited IRA.

2013-09026. The primary investment in the participant's IRA was "Investment X" (let's say). The financial institution serving as custodian of the IRA notified the participant at some time during Year 1 that it might not want to serve as custodian for this particular investment in the future. The participant spoke with the financial institution and its accounting firm about this and they said they were "looking into" ways to resolve the problem so they could remain as custodian. The participant heard no more about it until....the following January (Year 2) when she received a 1099-R indicating the investment had been distributed out of the IRA in November, Year 1! Yes, the custodian had simply distributed the investment out of the IRA into a taxable account with no notice whatsoever to the participant either before or after the distribution! Waiver granted.

2013-11039. The participant, on 10/20/11, called his financial institution/IRA custodian and requested an IRA distribution of a specified dollar amount (e.g. "One thousand dollars"). By mistake the IRA provider transferred to the participant's taxable account the specified number of SHARES of some fund or company rather than the specified number of DOLLARS. Apparently these shares were worth more than $1 each, so the distribution was of a much larger dollar amount than had been requested. The participant did not discover this until he received his account statement in January 2012. He sought from the IRS, and received, permission to do a late rollover of the excess distribution due to financial institution error.

2013-27020. When the CDs in P's IRA at FI "C" matured, she met with a representative of the FI to move the funds to a new investment, still in an IRA. She did not want to take a distribution, she wanted to keep the money in an IRA, but the rep of the FI was in a hurry and prepared forms for transferring to a taxable account, and didn't give her time to read them. She didn't discover the error until she got a 1099-R at tax prep time. Waiver granted.

2014-29032. Financial institution was supposed to transfer taxpayer's required minimum distribution from her IRA to her taxable account. Which it did. In fact they did it twice, due to a coding mistake. Taxpayer didn't notice the mistaken double distribution until the following year. Late rollover of second distribution allowed.

2015-24027. With the assistance of a representative of the bank, in 2008, taxpayer completed the form for creating a rollover traditional IRA and deposited her rollover check. The form "clearly indicated" the intent to roll into a traditional IRA. Instead, the bank put the money into a Roth IRA, a mistake that was not discovered until 2013, when the certificate of deposit matured. Late rollover allowed (for the original rollover amount, not the five years' worth of earnings).

(b) Financial institution error—FI provides erroneous info or advice

This group includes, in addition to flat-out erroneous advice/information provided to the taxpayer (or to his/her advisor) by the distributing or receiving financial institution, financial reporting that is misleading (*e.g.*, an account statement that does not reveal that the account is an IRA).

If the erroneous information or advice that caused the taxpayer to miss the 60-day rollover deadline came from someone *other than* the financial institution that made the distribution or received the rollover contribution (such as the taxpayer's personal financial advisor) see PLRs at (B)(2) instead.

2011-35034. Taxpayer A's husband died in 2005. Upon his death she learned for the first time that he had an annuity contract ("Annuity X") and that this contract now belonged to her. In 2008 she went to a financial advisor, who was concerned about the financial strength of Financial Institution A, the issuer of Annuity X, so helped her with the paperwork to cash out the annuity. The proceeds were placed in a taxable account. Neither Taxpayer A nor her financial advisor was aware that this contract was in fact an IRA annuity, because on all of Financial Institution X's monthly statements sent to Taxpayer A the annuity contract was listed in the group "Investments," not in the group "CD & Retirement." They did not find out it was an IRA annuity until a 1099-R was received the following year, by which time the rollover deadline had passed. Waiver granted.

2011-44040. The participant was granted a waiver where he received erroneous information from his employer about the taxable status of part of his LSD/NUA stock distribution.

2011-45029. Taxpayer A took a distribution from her IRA, then became aware of the undesired tax ramifications of taking an IRA distribution. A family member told her she could eliminate the tax by rolling over the distribution within 60 days, but when Taxpayer A "called the information line operated by Institution B" an employee of Institution B "incorrectly advised her that she was required to roll over the distribution in the same tax year, a deadline that had already passed." This erroneous advice was given within the 60-day period, but Taxpayer A relied on it and did not find out it was incorrect until after the deadline had passed. Waiver granted.

2011-50039. An employee of Company C helped Taxpayer A close his IRA and transfer it to a taxable account, but Company C admitted that the employee should have advised A that he needed to roll the funds into another IRA and the employee didn't do so. Waiver granted. This seems to suggest that Company C had assumed the obligation to advise A. Contrast this with PLR **2012-50031**. These rulings had different results on seemingly similar facts.

2014-16013. Financial institution informed taxpayer and her advisor (twice) that her account was not an IRA. The account statement did not reveal it was an IRA. So when taxpayer withdrew the money and transferred it to another institution, she did not put it into an IRA. Two years later the first institution informed her—actually it *was* an IRA! Late rollover allowed.

(c) Financial institution provides NO information/advice

In these ruling requests, the taxpayer claimed that he did not timely complete the rollover because he did not know about the need to roll over the money, and his lack of information was the fault of the distributing or receiving financial institution (the employer, the plan, the IRA provider). Whether this is grounds for a hardship waiver depends on whether the FI was obligated to provide the taxpayer with this information.

If the party that failed to advise was *obligated to advise*, then failure to advise is clearly grounds for a waiver. There are two ways such party might have such an obligation. First, when a distribution is made from a qualified plan, the employer or plan is obligated by the tax law to provide extensive information to the distributee regarding his/her tax options (see, *e.g.*, § 402(f))—and to offer the distributee a direct rollover if eligible (see § 401(a)(31(A)). So, failure to provide the statutorily required information is clearly grounds for a waiver of the 60-day deadline as "financial institution error."

In contrast to qualified plans, the administrator of an IRA is generally NOT obligated to provide information to a distributee regarding his/her tax options. The IRS has refused to grant waivers in some PLRs where the taxpayer's complaint was the IRA provider's failure to provide him/her with tax information. However, the IRA provider can assume that obligation—so if the taxpayer shows he/she was reasonably relying on advice from the IRA provider *based on the IRA provider's assumption of the obligation* to provide such advice, the taxpayer should get the hardship waiver.

2012-04025. An employee received a distribution or several distributions from the terminating retirement plan of his former employer, but failed to timely roll over the distributions due to lack of or incorrect information from his former employer (a problem compounded by erroneous advice from his tax advisor). Waiver granted.

2013-11042. A company made a plan distribution to a deceased employee's surviving spouse. Ignoring the requirements of § 402(f)(1), the plan administrator didn't bother to tell the widow about her rollover options for this distribution (just told her she could choose between a lump sum distribution and an annuity). Waiver granted due to financial institution error.

2014-32020. DENIED**.** Taxpayer closed out her IRAs at Financial Institution D but did not deposit the proceeds into new rollover IRAs until after expiration of the 60-day period. She said she was late because she relied on Financial Institution D "to provide guidance regarding the rules associated with her IRA investments, specifically the 60-day rollover period." The IRS refused to give her a waiver, because there was no documentation that the financial institution was her financial advisor: "...the Code imposes no...obligation on IRA custodians [to explain the 60-day rule]. Absent actions on the part of a financial institution undertaking such an obligation we do not recognize this failure as financial institution error."

2. The distribution was made in the form of a check which was misplaced and never cashed.

2014-07026. P retired from Employer in 2009. In 2013, while P was out of the country for an extended period of time, the plan administrator of the Employer's plan sent a letter addressed to P at his U.S. address that he had to take his money out of Employer's plan within 60 days because P had attained age 65 (this was a plan rule, not an IRS rule). P did not get any of his mail during his absence. The plan did not attempt to communicate with him otherwise than via this one letter (i.e., did not email or phone him). The plan mailed a check for the balance in P's account, minus withheld income taxes, to P's U.S. address, where it remained unopened and uncashed until P returned in June 2013. P received the letter when he returned from abroad in June, at which time he promptly (within 7 days) deposited the check in an IRA. The IRS waived the deadline with respect to the money that P had already deposited in the IRA, and also with respect to the withheld income taxes.

3. The distribution was deposited into and remained in an account that the taxpayer mistakenly thought was an eligible retirement plan.

Ruling examples not collected yet; the PLRs listed in ❦1.10(A) may contain some waivers granted on this basis.

4. The taxpayer's principal residence was severely damaged.

Ruling examples not collected yet.

5. A member of the taxpayer's family died.

Ruling examples not collected yet.

6. The taxpayer or a member of the taxpayer's family was seriously ill.

Many successful waiver requests have involved participants who were hampered from initiating and/or completing the rollover by significant mental or physical health problems (of themselves or 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.

A waiver is granted if the failure to complete the rollover within 60 days is due to a serious medical problem, as supported by documentation, as in all the following rulings:

2011-05046. "Severe medical condition which affected her ability to accomplish a timely rollover." This one is notable because part of the delayed rollover of her IRA distribution was to a Roth IRA, so she was allowed a "late" Roth conversion.

2011-35035. Both husband and wife withdrew from their IRAs, intending to roll over the money, then missed the deadline due to a sudden severe illness that struck wife, thus incapacitating her and also (as her principal care giver) husband. Double waiver granted (for the price of just one user fee).

2011-45028. Severe mental illness throughout the 60-day rollover period. Waiver granted.

2011-49046. Several debilitating medical issues and a severe reaction to a drug prescribed for one of the medical issues. Waiver granted.

2012-01019. During the 60-day period, taxpayer "became very ill, was hospitalized for a significant portion of the period, and was treated for cancer." Waiver granted.

2012-04024. "Prior to and during the rollover period, Taxpayer A experienced severe heart and vision problems, requiring surgery on both organs and subsequent periods of recovery. Documentation provided indicates that Taxpayer A's medical treatment and recuperation affected his ability to handle his financial and business affairs." A was age 79. Waiver granted.

2013-27023. Taxpayer received distribution and, while considering how to reinvest it, suffered an injury (during the 60-day rollover period) that required her to receive "home medical care for 10 days and her using a support walker." She was "unable to wear a shoe for several weeks" and was "prescribed pain medication ....which affected her ability to manage her financial affairs." Plus she is "of advanced age" (unspecified) and had no family living nearby. Waiver granted.

2013-30046. Taxpayer was overwhelmed by husband's death, by her 10 years as his care giver during his illness, by her own depression and physical ailments including near blindness, making her incapable of making financial decisions; thought the IRA she inherited and cashed out was a life insurance policy, didn't realize it was in fact a taxable IRA distribution until preparing her tax return the following April. Waiver granted.

7. The taxpayer was incarcerated.

Ruling examples not collected yet.

8. Restrictions imposed by a foreign country.

Ruling examples not collected yet.

9. Postal error.

Ruling examples not collected yet.

10. The distribution was made on account of an IRS levy under § 6331 and the proceeds of the levy have been returned to the taxpayer.

Ruling examples not collected yet.

11. The party making the distribution delayed providing information that the receiving plan or IRA required to complete the rollover despite the taxpayer's reasonable efforts to obtain the information.

Ruling examples not collected yet.

B. WAIVER REQUESTS FOR REASONS NOT ON THE LIST OF 11

There are several well recognized paths to qualifying for a hardship waiver of the 60-day rollover deadline that are *not* included in the list of 11 hardships on which self-certification can be based. These are causes that are listed in Rev. Proc. 2003-16, or that have been cited numerous times in PLRs granting hardship waivers, but that for some reason the IRS did not authorize for self-certification.

There are some excuses for which the IRS sometimes does and sometimes does not grant a hardship waiver. I do not think it is possible to reconcile the results in all the PLRs. Either there are factors that are not apparent in the PLR text, or the IRS has changed its policies over time, or different PLR-writers have different standards, or----what? If you are seeking a hardship waiver for one of these causes try to make your cause sound like one of the favorable PLRs.

1. Death of taxpayer.

See rulings collected at ¶ 4.1.04(C) of *Life and Death Planning for Retirement Benefits*.

2. Error by a financial advisor not part of a "financial institution"

Suppose the taxpayer reasonably relies on his financial advisor (FA) to carry out the rollover, and the FA makes a mistake, but the FA is an independent advisor who is not part of a "financial institution." This type of error does not appear to fit into the list of 11 "hardships" that justify self-certification. However, the IRS has granted many hardship waivers based on such facts.

2006-17039. DENIED. The IRS refused to grant a hardship 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 the special "net unrealized appreciation" (NUA) treatment (see ¶ 2.5 of *Life and Death Planning for Retirement Benefits*). After the 60-day rollover deadline had passed, he found out the distribution did *not* qualify for NUA 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. Compare this with **2011-44040** (in Group (A)(1)(b)).

2011-43027. GRANTED. 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. 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.

2012-01018. GRANTED. Taxpayer A's husband died suddenly. She received a distribution notice from husband's pension plan asking her if she wanted her benefits in a lump sum or in instalments. Taxpayer A (who was disabled and under age 59½) "was very distraught and overwhelmed" due to her husband's sudden death. She asked Financial Advisor X what to do. He advised her to take a lump sum, but did not advise her to roll over the distribution to her own IRA. His reason for this advice, according to his "signed notarized statement," was that he was aware she was under age 59½ and believed she would need to use the benefits prior to reaching that age, therefore, he did not think she should roll the money to her own IRA, from which she would not be able to withdraw money prior to reaching age 59½ without paying the 10% excise tax. He was NOT aware at the time that she was disabled, so she could withdraw even prior to age 59½ with no excise tax due to the disability exception. The waiver was granted because of Taxpayer A's "reliance on erroneous advice provided by Financial Advisor X."

Note: Financial Advisor X's advice was bad even based on his own rationale: Even if Taxpayer A were not disabled (and therefore not eligible for that exception to the excise tax), she could have retained her right to take excise tax-free distributions from husband's plan by requesting a direct rollover of the benefits into an "inherited IRA" in husband's name, rather than into her own IRA. See ¶ 3.2.07 of *Life and Death Planning for Retirement Benefits* for discussion of this option. Regarding the 10 percent excise tax on pre-age 59½ distributions generally, see Chapter 9 of *Life and Death Planning for Retirement Benefits*; for more on the disability exception, see ¶ 9.4.02; for an under-age-59½ surviving spouse's choices, see ¶ 3.2.08.

2012-50031. DENIED. See discussion of this PLR in Group (B)(2).

2013-11043. GRANTED. An individual (age 91) took a distribution from his IRA, planning to roll it over to a different financial firm for investment reasons. But his accountant advised him more than once that this distribution would be tax-free because the income could be offset against some losses the individual had incurred in the same year, so the individual did not roll over the distribution. However, when it came time to prepare the income tax return, the accountants realized that the capital losses could not in fact be offset against the ordinary income of an IRA distribution. The IRS granted a waiver of the rollover deadline because the failure to complete the rollover within 60 days "was due to misleading tax advice from his CPA."

2013-27021. GRANTED. In March, the participant met with his "financial advisor's assistant" to arrange taking the 2012 required minimum distribution (RMD) from his IRA, "Amount 1." He requested a distribution of a certain amount of cash plus enough shares "from Fund F" (to be distributed in kind) so that the total distribution would equal Amount 1. Instead, the assistant caused all shares of Fund F to be distributed, thus causing the distribution amount to exceed the RMD by "Amount 3." The participant did not discover the error until October. Waiver granted.

2014-07027. P had a plan loan outstanding with his employer's 401(k) plan. His employment was terminated but for a while he continued to receive paychecks with loan payments deducted from them. When the paychecks stopped, he was erroneously told by a financial advisor that he didn't need to do anything about the loan. In fact the loan (as required by the loan documents and explained in the summary plan description) was paid off by a deduction from his 401(k) account when he stopped making payments. That payoff was considered a distribution. P was unaware of it. The IRS granted him a waiver because of the erroneous advice of the financial advisor.

3. Taxpayer did not know distribution occurred: Fraud cases

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, or the participant was mentally incompetent to understand the consequences of withdrawing the funds.

For additional "involuntary distribution" PLRs, see (in addition to the PLRs summarized in #3, #4, and #5) PLRs 2004-21009, 2004-21008, 2004-27027, 2004-35017, 2004-36014, 2010-15040, and 2010-16093.

2011-16040. On the advice of Individual M, Taxpayer A established "IRA Y" with Company H and transferred Amount B to it from his prior IRA. IRA Y was supposed to be a "self-directed" IRA. Through a series of steps the money was channeled to "Company J" inside IRA Y. Apart from one distribution he received, however, Individual A was defrauded—all the IRA money and another (nonIRA) investment account were apparently stolen by Individual M. We are told that Taxpayer A's "personal efforts resulted in a total recovery" of the missing IRA and nonIRA funds equal to Amount F, which A deposited in a bank then moved to another bank then attempted to deposit in a rollover IRA. The IRA custodian would not accept the deposit because there was no proof it had come from another IRA.

The IRS allowed a late rollover, because the failure to complete a timely rollover was due to the facts that Taxpayer A had been defrauded and that banks would not accept his attempted rollover deposit due to lack of evidence that it came from an IRA. Two facts of note:

✓ Because Taxpayer A's recovery included both IRA and nonIRA funds, he was permitted to roll over only a "pro rata portion" of the recovery representing the IRA portion. The fraction was, the amount that was supposed to be in the IRA when the fraud was discovered ("Amount L"), divided by the sum of Amount L and the amount of A's nonIRA investment that was stolen, times the amount of the recovery=amount that can be rolled over.

✓ It does not appear that Taxpayer A obtained any kind of legal judgment or arbitration award against the defrauder. It is not mentioned that Taxpayer A even brought any kind of legal action or formal proceedings, only his own “personal efforts.”

2011-17039. “Taxpayer A and Taxpayer B” (presumably husband and wife, though this is not stated) withdrew money from their respective IRAs, intending to roll the amounts over to another IRA with more conservative investments within 60 days. Meanwhile, they both deposited their distributions in a taxable account, “Account E” with “Fund F.” But “federal authorities discovered that Fund F was operating a Ponzi scheme,” and before A and B completed their rollovers the feds froze Fund F, and placed the company in receivership, so A and B were not able to withdraw their money in time to complete the rollover within 60 days. Waiver was granted because their “failure to accomplish a timely rollover was caused by the fraudulent and illegal actions of Fund F.” Points of interest in this ruling:

✓ First note that A and B got this ruling jointly, thereby apparently saving a “user fee” (IRS filing fee for a PLR).

✓ Second, the ruling does not mention how much A and B eventually recovered from the fraudulent “Fund F” or even whether they ever recovered anything at all. This leads to the impression that A and B completed their rollovers using substituted funds rather than using proceeds actually recovered from Fund F. But if they HAD other money to use to complete the rollover why didn’t they do so within 60 days?

✓ Third, the fact that an IRA investor who has been defrauded can complete his rollover using substituted funds means that a wealthy individual who has plenty of bucks “outside” his IRA as well as “inside” it will be able to fully replace his tax-favored IRA account regardless of whether he ever recovers anything from the fraudster. In contrast, someone who had all of his assets in the IRA will only be able to replace the IRA to the extent he actually gets a recovery from the fraudster and/or its accomplices.

2011-43029. After much research, and based on representations of Individual B, Taxpayer A moved “Amount A” from his IRA to a “self-directed IRA” with Financial Institution S (FI-S). The U.S. Attorney indicted FI-S and Individual B for conducting Ponzi scheme fraud through, among other means, self-directed IRAs, and sought forfeiture of “all assets under the control of” FI-S so it could apportion the assets among the defrauded investors. The IRS allowed Taxpayer A to do a late rollover of “Amount A” to a (real) IRA, because “his failure to accomplish a timely rollover was due to the fraudulent misrepresentation by Individual B that Financial Institution S could act as custodian for self-directed IRAs.” Reading between the lines, though this fact is never explicitly stated, it would appear that FI-S took Taxpayer A’s IRA distribution money (Amount A) but never actually placed it in an IRA. Thus, Taxpayer A was enabled to do a late rollover of the full amount without waiting for the outcome of the U.S. Attorney’s proceedings. What’s interesting here is that we have no idea how much Taxpayer A lost in the fraud scheme (or whether he even lost anything at all).

2013-24022. **Wife defrauded by husband**. Wife (not a lawyer) married Husband (a lawyer) in 2001. As part of their estate planning process in 2004 they gave each other powers of attorney, intended to be activated upon incapacity. Sometime after that, Husband used Wife's power of attorney to withdraw money from her IRA without her knowledge, representing to the financial institution involved that the money was needed for Wife's medical expenses which was not true. Husband in fact lost the money gambling. Wife discovered the withdrawals later. Husband was treated for a gambling addiction. IRS granted her a hardship waiver of the 60-day rollover deadline, allowing her to redeposit some or all of the withdrawn funds into an IRA.

4. Taxpayer did not know distribution occurred: Lack of mental capacity

2013-11037. Husband and wife both sought waivers. The wife had handled all their financial affairs, but her mental condition deteriorated and while she was in that state she had withdrawn all the funds from both spouses' IRAs. She did not understand what she was doing, and did not believe people who tried to explain the consequences of these withdrawals to her. The IRS granted a hardship waiver to allow the funds to be returned to the IRAs.

2013-11038. Similarly involved a hardship waiver due to a deteriorated mental condition.

2013-25022. Taxpayer, who suffered dementia as diagnosed by 2 physicians, withdrew from his IRA. He was not capable of making financial decisions. His wife held his power of attorney, did not discover the withdrawal until the following April when preparing tax return. Granted permission to make late rollover using the power of attorney.

5. Emotional distress/family turmoil

2011-13013. Severe emotional distress, depression and insomnia caused by marital separation and divorce. Waiver granted.

6. Rollover deadline occurred on weekend/holiday

In these rulings the IRS granted hardship waivers to people who waited until the very end of the 60-day period, then discovered that the banks were closed because the 60th day fell on a weekend. The IRS has granted hardship waivers of the 60-day rollover deadline in several cases where the deadline fell on a weekend or other "bank holiday." See PLRs **2006-06055, 2009-30052, 2009-51044, 2009-52066,** and **2010-39041.** Apparently the people in these rulings waited until the last minute and then realized, too late, that banks are closed on weekends. To the IRS, that's a hardship!

7. Taxpayer's mistake; no professional advisor; waiver usually denied

The IRS tends to deny the grant of a hardship waiver when the 60-day rollover deadline is missed simply because of the taxpayer's own carelessness. When there's no handy financial advisor or financial institution error to point the finger at. When there's no extraneous hardship like an

illness, catastrophe, death in the family, etc. that caused the taxpayer to miss the ball. When the taxpayer simply blew it. The IRS in these cases recites that "none of the factors" listed in Rev. Proc. 2003-16 (the Revenue Procedure that established the procedures and standards for hardship waivers of the 60-day rollover deadline) is present.

However, the IRS is not consistent. As the following PLRs show, there is little (no?) apparent difference between some cases where the careless taxpayer received a hardship waiver and some other cases where the waiver was denied.

When the IRS refuses to grant a waiver, the refusal is always accompanied by the mantra that the taxpayer "has not presented any evidence as to how any of the factors outlined in Rev. Proc. 2003-16 affected" the taxpayer's ability to complete the rollover. See, *e.g.*, PLRs **2007-27023, 2007-30023, 2010-15039,** and **2010-15039**.

This litmus test has been applied, for example, to deny a taxpayer a late rollover when he himself made a mistake in filling out the rollover form (see, *e.g.*, PLRs **2010-02049, 2010-03030, 2010-06035, 2010-07080, 2010-15039,** and **2010-37038**), while taxpayers are routinely granted the waiver if the paperwork error was made by the individual's financial institution or advisor. When the taxpayer (having stupidly failed to hire a pro to handle his rollover) bungles the paperwork, the IRS haughtily declares that "the ability to complete the rollover on time was at all times within your own control" so no waiver can be granted. However a paperwork snafu by the participant *accompanied by serious illness* may be sufficient; see **PLR 2011-35035**.

And yet...In **PLR 2011-50038 (12/16/11)**, the IRS gave an individual a hardship waiver under the following circumstances. On March 14, "P" requested a distribution from his IRA (in order to make an investment change). On March 21, he received a check dated March 15th. He placed the check in a safe in his office. He believed he had until 60 days from the date of the check (i.e., until May 14th) to complete the rollover. Though the ruling is sketchy, he apparently missed that deadline—and applied to the IRS for a hardship waiver before the *actual* deadline (which the IRS seems to be implying was 60 days after receipt of the check) had passed! This misunderstanding of the rules was not stated to be based on any erroneous advice from a financial advisor or institution; the funds (the uncashed check) were at all times within the taxpayer's control; and none of the factors listed in Rev. Proc. 2003-16 was present—at least none is mentioned in the ruling. And yet this guy gets a hardship waiver!

2012-06023. DENIED. Taxpayer A (age 86) *said* the reason his missed the deadline was that he was told by an employee of the IRA provider-company from which he took the distributions to be rolled over that he had 90 days to complete the rollover. But Taxpayer A had no "documentation" of this "alleged financial institution error" other than his own statement. I guess the IRS didn't believe his story—another lying old codger!—so they denied the waiver. Contrast 2012-27009 where the IRS believed the taxpayers' statements.

2012-27009. GRANTED. Husband and wife took distribution checks from their IRAs, intending to roll them over to other IRAs they maintained, at Financial Institution B. The wife claimed she called Financial Institution B to get the mailing address for rollovers, then mailed the checks to that address, but the checks were returned by the Post Office after the 60-day deadline had passed. Unlike in PLR 2012-06023 above, The IRS accepted the taxpayers' statements (about the advice they

received, when they mailed the checks, and where they mailed them to) and granted the waiver of the rollover deadline. Note that the IRS allowed the spouses to apply jointly for a hardship waiver of the 60-day rollover deadline that will cover both of their accounts, thus saving the cost of one IRS "user" (filing) fee.

2012-27011. DENIED Taxpayer A, age 60, got a distribution check and put it in a pile of papers on his desk. He intended to roll it over within 60 days, but "inadvertently left the check among financial papers and overlooked rolling it over." None of the "factors" cited in Rev. Proc. 2003-16 was present. The IRS denied the waiver.

2012-50031. DENIED. "Taxpayer A" was dissatisfied with the returns he was receiving on his IRAs invested with Financial Institution A (FI-A) and discussed the problem with his financial advisor "Individual I" who worked at FI-A. The advisor told him that FI-A could not get him a better rate and that he would need to withdraw his funds from FI-A and deposit them elsewhere. Although the participant apparently intended to roll the funds into new IRAs at the new financial institutions he had selected (FI-B and FI-C), he in fact deposited the funds into taxable joint accounts with his wife. And of course he didn't discover this mistake until he received 1099-Rs the following year showing full taxable distribution of the IRA.

What is unusual about this PLR is that the advisor, Individual I, gave the participant an affidavit to submit to the IRS in which Individual I said he failed to adequately advise the participant about the tax effects and the rollover procedures, and "ensure that the funds were actually deposited into rollover IRAs" as the customer intended. Nevertheless the IRS refused to grant a waiver, saying that "Individual I had no duty to ensure that the rollovers were completed correctly once the funds were distributed to Taxpayer A." The taxpayer "assumed the risk" of attempting the rollover without the benefit of professional advice.

2013-09023. DENIED. A husband and wife both withdrew funds from their IRAs at "Credit Union E" and placed the funds in their taxable accounts at the credit union. The withdrawal form they signed clearly flagged the 60 day rollover requirement. Apparently the couple did not realize how high the taxes would be on these distributions until they prepared their joint tax return the following year. Their only claim of hardship was inadequate disclosure of the 60-day rollover requirement, but the IRS found that they did have notice of that deadline and declined to grant a waiver.

2013-28036. DENIED. Both husband and wife had IRAs at "Institution C." Both were unhappy with the investment choices and/or fees at Institution C, and (according to them) they verbally instructed Institution C to send the funds to IRAs established for them at Financial Institution E. However they did not have IRAs at FI "E," so the funds were transferred into Wife's taxable account at FI "E," where they languished until after expiration of the 60-day rollover window. The spouses did not submit any evidence that they had even applied to open IRAs at FI E, nor did they explain why they had not noticed the mistake on the regular financial statements they received with respect to the taxable account at FI E. Waiver denied.

2013-31012. DENIED. A tax preparer mentioned to her client that the client might be able to cash out *some* of her IRA tax-free if she had enough deductions to offset the income, and "provided a brief example" of this planning idea. Taxpayer (stressed out by her husband's recent death) misunderstood this advice, cashed out her whole IRA, spent the money, then sought a late rollover when confronted with the tax consequences of the distribution. The stress was documented by "letters from several health providers." Wavier denied. Failure to understand tax advice is not one of the factors outlined in Rev. Proc. 2003-16.

C. FACTORS THAT MAY SUPPORT OR IMPAIR HARDSHIP WAIVER CLAIM

1. Taxpayer did or did not spend the money

The IRS normally refuses a waiver when the taxpayer deliberately took the distribution with the intent to spend it or invest it elsewhere (*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.

2. How much time has passed since the distribution occurred?

There is no official amount of time beyond which it becomes too late to request a hardship waiver of the 60-day rollover deadline. A 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; see ¶ 8.1.03).

3. Taxpayer's original intent regarding the distribution

The taxpayer's original intent when he/she took the distribution (i.e., regarding whether he/she would roll it over or not) seems to be a factor influencing the IRS's rulings. If the taxpayer clearly intended to roll over the distribution, that is helpful.

If the taxpayer apparently didn't originally intend to roll over the distribution, and decided to try for a rollover only later (perhaps when he/she realized how high the taxes would be) that is not helpful. See PLR 2013-09023.