IRS Issues IRA Rollover Warning

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A new ruling from the IRS could mean big changes for client retirement assets.

As a result of a recent U.S. Tax Court decision, the IRS has changed its interpretation of the "once per year" IRA rollover rule to mean exactly that: Only one IRA-to-IRA rollover is permitted during a 365-day period from any of a client's IRAs.

The new rule will not be enforced until Jan. 1, 2015, giving advisors and financial institutions time to gear up.

The good news here for advisors is that clients who have already done multiple rollovers from separate IRAs will not have to worry about them. The IRS has effectively grandfathered them by delaying the effective date of the new rule. But from now on, you should have your clients stop this practice and use direct (also called trustee-to-trustee) transfers instead.

Simply put, the once-per-year rollover rule states that an owner can roll over only one IRA distribution to another IRA within a one-year period. The one-year period is 365 days, not a calendar year, and starts on the day the IRA owner receives the distribution.

Example: A client takes a distribution from her IRA on Dec. 10, 2015, and rolls it over within 60 days. In March 2016, she takes another distribution from her IRA. That March distribution cannot be rolled over to another IRA because the one-year period runs from Dec. 10, 2015, to Dec. 10, 2016.

As a result, this second distribution is generally taxable. If a client is under age 59½, it would be subject to a 10% early distribution penalty too.

There are some exceptions to the once-per-year rollover rule. Among them: IRA to Roth IRA conversions, first-time homebuyer distributions that are canceled or delayed; and qualified reservist distributions that are timely repaid. The rule also does not apply to rollovers made from or to an employer retirement plan, like a 401(k).

SIGNIFICANT CHANGE

The new rule is a significant change. For many years, IRS Publication 590, *Individual Retirement Arrangements*, said that if an individual has more than one IRA, the rollover rule applies separately to each IRA. The IRS also backed up this stance in two private letter rulings -- one dated June 28, 1996, and one from May 6, 1987.

But all this was upended in late January by a Tax Court decision in *Alvan L. Bobrow et ux. v. Commissioner*.

In the underlying case, Alvan and Elisa Bobrow -- a married couple -- held multiple accounts at Fidelity Investments. On April 14, 2008, Alvan received two distributions totaling $65,064 from one IRA. Shortly after, on June 6, he received another $65,064 distribution from a second IRA. On June 10, Alvan moved $65,064 from his individual checking account into the first IRA.

Then on July 31, 2008, Elisa received a $65,064 distribution from her IRA -- and on Aug. 4, the Bobrows moved $65,064 from one of their checking accounts to Alvan's second IRA. Because this was within 60 days of Alvan's June 6 IRA distribution, the move was intended to complete a tax-free rollover of those funds.

AN IRS BILL

The IRS scrutinized the Bobrows' 2008 IRA distributions and concluded that some of them weren't eligible for rollovers. The IRS asserted that Alvan's April 14 distribution and Elisa's July 31 distribution were taxable and sent the couple a notice for unpaid income taxes of $51,298, resulting from the two ineligible rollovers. The couple were also hit with an accuracy-related penalty of $10,260.

The couple disagreed with the IRS and the issue wound up in Tax Court.

The court decided that the IRS had correctly assessed the Bobrows' tax liability but, in a curveball, used different reasoning than the IRS had used.

Instead of taking the view that the Alvan's first rollover was taxable because it was ineligible for rollover, the Tax Court ruled that Alvan violated the once-per-year rollover rule when he tried to roll over his second IRA distribution, taken in June 2008 -- even though the distribution came from a different IRA.

Despite all the guidance to the contrary -- not to mention the Bobrows' arguments -- the Tax Court decided the once-per-year rollover rule applies to all of a taxpayer's IRAs together, not individually. Its rationale was that the language of the tax code limits a taxpayer to one rollover per year, with no qualifiers.

The Bobrows argued that the 20% accuracy-related penalty should be waived for reasonable cause. But while the court repeatedly asked them to cite an authority for their position, Alvan Bobrow, who happens to be a tax lawyer, didn't mention Publication 590, the private letter rulings or a proposed regulation that echoes Publication 590. (If he had, the court might have determined that the Bobrows acted reasonably and should be spared the penalty.)

The court said that Congress put limits on IRA rollovers to ensure that taxpayers don't take advantage of the 60-day rollover rule by repeatedly moving funds in and out of their IRAs on a tax-free basis.

In other words, the court felt Congress wanted to avoid having taxpayers game the system, as the Bobrows tried to do -- artificially creating a rollover period longer than 60 days. The couple's IRA transactions let the Bobrows use that $65,064 for more than 60 days. They appeared to be

trying to "extend" the 60-day rollover period by doing multiple withdrawals and rollovers.
In late March, the IRS issued Announcement 2014-15, which spelled out the new rules: Beginning in 2015, the once-per-year rule would mean one IRA-to-IRA rollover (or one from Roth IRA to Roth IRA) per taxpayer, per 365 days -- regardless of how many different IRAs a person has.

Both the court and the subsequent IRS ruling reminded taxpayers that there is no limit on the number of direct transfers between IRAs -- that is, where the individual doesn't use or control the funds -- because transfers aren't considered distributions or rollover contributions.

ADVISORS' ROLE

There are a few key takeaways here.

As always, advisors should have clients do direct (trustee-to-trustee) transfers when moving funds between IRAs. This will avoid all the once-per-year problems. A violation of the rule can be fatal to the IRA funds being moved, with no IRS relief available. While the IRS has the authority to waive the 60-day rollover rule, it may not waive the once-a-year IRA-to-IRA rollover rule. When this rule is violated, the extra rollover amount is taxable and may be subject to the 10% early distribution penalty.

Even worse, if the funds are rolled over in error, the action will be treated as an annual IRA contribution and could result in an excess contribution, triggering the 6% penalty on such amounts. Indeed, any excess amounts will be subject to the 6% penalty for each year the excess remains in the account.

That could lead to even more tax problems, because that 6% penalty is reported on IRS Form 5329 -- which typically is not filed by clients unless they are reporting a penalty. If they haven't filed the form, then the three-year statute of limitations clock never starts ticking -- which in turn means that the IRS can go back indefinitely and assess the 6% penalty, for each year, on the excess amounts.

This is a potentially costly tax trap. It is critical that you inform your clients of this major change for IRA rollovers.

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