Sorting out the Timing Rules for Traditional and Roth IRAs

IRAs and Roth IRAs give taxpayers a great deal of flexibility in tax sheltered retirement planning, but along with flexibility comes complexity. Taxpayers can make annual contributions to traditional or Roth IRAs, make rollovers as well as trustee-to-trustee transfers, convert traditional IRAs into Roth IRAs, and recharacterize contributions or conversions to Roth IRAs. Even a conversion which is reversed by way of a recharacterization can later be reconverted. The permutations are enough to make your head spin, particularly when it comes to figuring out what can be done, and by when. To complicate matters, a more restrictive one-year wait period between rollovers will apply beginning in 2015. This Hot Topic should help. It sorts out the traditional and Roth IRA timing rules for regular contributions, rollovers, trustee-to-trustee transfers, conversions, recharacterizations, and reconversions, and offers practical suggestions on how to keep the complications to a minimum. This article covers the timing rules for traditional IRAs.

- **Contributions to traditional IRAs.** A traditional IRA must be established no later than the unextended due date of the taxpayer's income tax return for the year the deduction is claimed. And, for a contribution to be deductible for a given year, it must be made by that date.

- **Tax-free rollovers from one traditional IRA to another.** A tax-free rollover involves withdrawing cash or assets from an IRA and then timely redepositing them to the same (or another) IRA.

  For example, a taxpayer may need an immediate infusion of cash for an emergency or for an investment opportunity. Alternatively, the taxpayer simply may want to dispose of an investment held in an IRA (e.g., a long term certificate of deposit) and hold it in a regular account until he decides how to reinvest the proceeds.

  Although such rollovers are reported on the tax return, they are tax-free if the 60-day timing rule and the one-year waiting period rule (see below) are both satisfied.

- **60-day timing rule.** For a rollover to be tax-free, the amount distributed from the traditional IRA generally must be recontributed to a traditional IRA no later than 60 days after the date that the taxpayer *received* the withdrawal from the IRA. The IRS may waive the 60-day rule if an individual suffers a casualty, disaster or other event beyond his reasonable control, and not waiving the 60-day rule would be against equity or good conscience.

- **Automatic waiver for failures caused by financial institution error.** The 60-day rule is waived automatically if a financial institution's error caused the rollover to be untimely. The automatic waiver is granted only if:

  ♦ the financial institution received the funds on behalf of the taxpayer before the 60day rollover period expires;

- ♦ the taxpayer followed all of the financial institution's procedures for depositing the funds into an eligible retirement plan within the 60-day period (including giving instructions to deposit the funds into an eligible retirement plan);

- ♦ solely due to the financial institution's error, the funds are not deposited into an eligible retirement plan within the 60day rollover period;

- ♦ there would have been a valid rollover, if the financial institution had deposited the funds as instructed; and

- ♦ the funds are actually deposited into an eligible retirement plan within one year from the beginning of the 60-day rollover period.

  Observation: Examples of financial institution error are (1) failure, due to a bookkeeping error, to credit the taxpayer's IRA rollover account until after the 60-day period had expired, and (2) an erroneous deposit to a non-IRA account of the taxpayer.

- **Private letter ruling process for obtaining waiver of the 60-day rule.** Taxpayers who don't qualify for automatic waiver of the 60-day rule may be able to obtain a waiver by applying for a private letter ruling. Under this process, the IRS will waive the 60-day rule where failing to do so would be against equity or good conscience, including casualty, disaster or other events beyond the taxpayer's reasonable control. More specifically, IRS will consider all relevant facts and circumstances, including:

  (1) errors committed by a financial institution (other than as described under the automatic waiver process);

  (2) the taxpayer's inability to complete a rollover due to death, disability, hospitalization or incarceration;

  (3) restrictions imposed by a foreign country;

  (4) postal error;

  (5) if and how the amount distributed was used (for example, in the case of payment by check, whether or not the check was cashed); and

  (6) the time elapsed since the distribution occurred.

  Observation: The best way to avoid problems with the 60-day rollover rule is to avoid going to the wire when completing the rollover. Where possible, the taxpayer should leave sufficient time to fix any problems which surface (e.g., erroneous rollover to a non-IRA account) before expiration of the 60-day period.

- **One-year wait period.** A tax-free rollover from one IRA into another IRA may be made only once a year (a limited exception applies for pay-outs from certain failed

financial institutions). The one-year wait period begins on the date the taxpayer receives the IRA distribution, not on the date when he rolls it over into another IRA.

For years, IRS had taken the position that the one-year rule applies separately to each IRA an individual owns. Thus, under this long-held position, if an individual maintains two IRAs, IRA-1 and IRA-2, and rolls over the assets of IRA-1 into IRA-3, he was not prevented from making a tax-free rollover from IRA-2 to IRA-3 or to any other IRA within one year after the rollover from IRA-1 to IRA-3.

However, IRS's position on the one-year rule was upended by a recent Tax Court opinion, which held that the one-year limitation applies to a taxpayer's IRAs on an aggregate basis. This means an individual can't make an IRA-to-IRA rollover if he or she made such a rollover involving any of the individual's IRAs in the preceding 1-year period.

In response, the IRS recently said it intends to withdraw the current proposed regulations, issue a revised proposed regulations, and revise Publication 590, to reflect the Court’s decision. However, the IRS will not apply the decision to an IRA distribution occurring before January 1, 2015.

> **Illustration:** In March of 2014, a taxpayer withdraws the balance from IRA-A and rolls it over into IRA-C within 60 days. In August of 2014, he withdraws the balance from IRA-B and rolls it over into IRA-D within 60 days. The taxpayer hadn't previously made any rollovers. Neither withdrawal will be taxable. But if these same transactions were to occur in 2015, only the withdrawal from IRA-A would be tax-free. The second withdrawal from IRA-B would be subject to tax and also could be subject to the 10% early withdrawal tax on the amount included in gross income. The deposit into IRA-D could be an excess contribution subject to a 6% tax, although that tax wouldn't apply if any excess contribution was withdrawn by the return due date for the year of the attempted rollover.

For purposes of the one-year wait period, none of the following are treated as rollovers from an IRA:

(1) a distribution from a qualified plan that is rolled over to an IRA;

(2) a direct, trustee-to-trustee transfer to an IRA;

(3) a conversion of a traditional IRA to a Roth IRA; or

(4) the recharacterization of a contribution.

Trustee-to-trustee transfers of traditional IRA funds. Direct, trustee-to-trustee transfers aren't rollovers because the transferred funds are not within the direct control and use of the taxpayer. Thus, direct, trustee-to-trustee transfers aren't subject to income tax, aren't reported on the taxpayer's return and aren't subject to the once-a-year limit which applies to IRA rollovers.

- **Transfers from qualified plans to IRAs.** A taxpayer may make a tax-free rollover of an eligible rollover distribution from a qualified plan to another eligible retirement plan, which includes traditional IRAs. The rollover may be made by way of a distribution followed by a contribution to an IRA within 60 days of the distribution, or by way of a trustee-to-trustee transfer.

  Observation: A distribution followed by a timely contribution to an IRA will be subject to mandatory 20% withholding under the Code, but a trustee-to-trustee transfer will escape withholding.

- **Tax-free rollovers from IRAs to qualified plans.** A taxpayer won't pay tax on a withdrawal from a traditional IRA if it's rolled over within 60 days to an employer-sponsored qualified retirement plan (e.g., 401(k) or profit-sharing plan).

  Caution: Taxpayers should keep in mind that under the regulations, qualified plans may, but are not required to, accept rollovers from an eligible retirement plan. Thus, a plan can refuse to accept rollovers. Alternatively, a plan can limit the circumstances under which it will accept rollovers. For example, a plan can limit the types of plans from which it will accept a rollover or limit the types of assets it will accept in a rollover (such as accepting only cash or its equivalent).

A special rule applies to taxpayers that have basis in their IRAs (i.e., they made nondeductible contributions to their traditional IRAs). Normally, in this situation, any distribution is treated as including taxable and nontaxable amounts. Without a special rule, the nontaxable portion of the distribution couldn't be rolled over. However, under the special rule, a distribution rolled over into an eligible retirement plan other than an IRA is treated as including only otherwise taxable amounts if the amount the taxpayer either leaves in his IRAs or does not roll over is at least equal to his basis.

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