Rollover caveats

IRAs have become a mainstay in many retirement portfolios, very often as receptacles for lump sum distributions from employer plans. Here are three private letter rulings that illustrate some of the complexities that may come with these accounts. The names in these otherwise true examples are fictitious.

How to fix a mistake

Believing himself eligible, Andy converted his traditional IRA to a Roth IRA on September 20. Late that year Andy received large, unexpected distributions of capital gains from his mutual funds. The gains were large enough to push Andy beyond the $100,000 AGI limit for conversions to a Roth IRA. He immediately told the IRA custodian to convert back to traditional status. Accordingly, Andy did not report the conversion on his Form 1040 that year.

Some years later, after the statute of limitations had closed for the year of the conversion and recharacterization, Andy was consolidating his retirement accounts. He discovered that the IRA custodian failed to follow his instructions regarding the recharacterization. So now it looks as if Andy did a conversion that he was not allowed to do and never reported it!

Andy contacted IRS, asking to be allowed to recharacterize the Roth IRA as a traditional IRA. IRS gave him the go-ahead, because (1) Andy took the initiative, contacting IRS before the Service identified the problem; (2) Andy had not made additional contributions to the account; (3) the error was the financial institution's; and (4) Andy acted in good faith throughout. What's more, there is no revenue loss to the government if the relief is granted, and no returns for closed tax years will be affected, as Andy did not report the original attempted conversion.

Don't retitle the asset

In May 2006 Bob decided to diversify his IRA. He purchased two IRA annuities and took a cash distribution. On June 1 Bob and his wife used that cash to acquire a jointly held certificate of deposit. Bob claims that he told the bank officer that the money came from his IRA, and he thought that the joint CD also would be an IRA. If it wasn't, he says, it was the bank's fault, so he should be allowed to cure his faulty IRA rollover attempt now.

No, says IRS. There was nothing about the CD form that Bob and his wife signed that suggested it was an IRA, and it was unreasonable of him to think that it was. What's more, qualified IRAs may not be owned jointly. The amount of the withdrawal transferred to the CD must be included in taxable income (and a penalty could apply if Bob is under age 59 ½).

Conversion to cash

The final ruling in this trio includes a mistake that is all too easy to make.

At age 56 Cindy began to receive regular distributions from IRA X in an amount intended to be substantially equal periodic payments for her life under IRC §72. As such, the distributions are exempt from the penalties for premature distributions.

At a later time, Cindy became nervous about the financial markets, and she worried whether she might exhaust her IRA too early in her retirement. She asked her custodian to move some of her money from stocks to FDIC-insured certificates of deposit, so as to minimize the risk of capital loss. Unfortunately, the company that was managing her IRA did not offer CD investments, so Cindy was advised to transfer the IRA money to another financial institution. She arranged for a trustee-to-trustee transfer of a portion of IRA X, as well as all of IRA Y, into a new IRA Z at a new company.

That happened in January. In May, when she went to the new IRA custodian to arrange for the transfer of the balance of IRA X, Cindy was told that the partial transfer might have constituted a modification to her series of periodic payments from the IRA. Why she wasn't told about this earlier is not stated. Nevertheless, Cindy asks IRS to rule that the trustee-to-trustee transfer was not a modification of her annuity stream, or if it were, she asks to be allowed to take corrective action, to move money and related earnings around so as to negate fully any such modification.

No and no, rules IRS, taking a hard line. The nontaxable transfer of a portion of the IRA account balance to another retirement plan is a prohibited modification, and no corrective action is recognized by the tax law. Accordingly, all of her IRA distributions are subject to the 10% penalty tax, going back to when she began them at age 56.

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