

## Sorting out the timing rules for traditional and Roth IRA

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 that 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. This article 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. Part I of the article covers the timing rules for traditional IRAs; Part II will cover the timing rules for Roth IRAs.

### PART I

Contributions to traditional IRAs. For 2005, an under-age-70-1/2 individual who isn't an active participant in an employer-sponsored retirement plan (and whose spouse isn't an active participant), can make a deductible contribution to a traditional IRA equal to the lesser of (1) \$4,000 (\$4,500 if he is age 50 or older), or 100% of the compensation that's includible in his gross income for that year. ( Code Sec. 219(b)(1) ). The deduction phases out if he (or his spouse) is an active plan participant and has adjusted gross income (AGI) that exceeds an "applicable dollar limit" (e.g., for 2005, \$75,000 for joint filers).

An individual who files a joint return and has less taxable compensation than his spouse may contribute to a spousal IRA and deduct the lesser of (1) \$4,000 for 2005 (\$4,500 if 50 and older), or (2) the sum of both spouses' includible compensation for the tax year, reduced by the sum of the spouse's allowable IRA deduction, designated nondeductible IRA contribution, and Roth IRA contribution for that tax year. ( Code Sec. 219(c) ).

An active participant in a qualified plan who may not be eligible to make deductible contributions either in whole or in part to a traditional IRA can make designated nondeductible contributions (DNCs) to an IRA for a tax year. ( Code Sec. 408(o)(2)(C)(i) ).

The amount of any DNCs made in 2005 is limited to the excess of: (1) the lesser of \$4,000 (\$4,500 for those 50 and older), or 100% of compensation (including the higher-earning spouse's compensation), minus (2) the amount allowable as a deduction for IRA contributions. ( Code Sec. 408(o)(2)(B)(i) ).

Observation: A nondeductible contribution to a traditional IRA produces no initial tax savings, but the earnings generated by the contribution compound tax-deferred until distributed. Roth IRA contributions also are nondeductible and compound tax-deferred, but distributions may be tax-free when distributed. Thus, nondeductible contributions to a traditional (non-Roth) IRA generally should be made only by those with incomes above the Roth IRA contribution threshold (see below).

Timing. The 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. The contribution (whether or not deductible) also must be made by that date. ( Code Sec. 219(f)(3) , Code Sec. 408(o)(3) ).

Tax-free rollovers from one traditional IRA to another. A tax-free rollover involves taking assets out of an IRA and then redepositing them to the same (or another) IRA within 60 days. For example, a taxpayer may need an immediate infusion of cash for an emergency or for an investment opportunity. If the money is rolled back into an IRA within the 60-day limit, the taxpayer has obtained a tax-free loan from his IRA. Rollovers from a traditional IRA can only be made once a year.

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. ( Code Sec. 408(d)(3)(A) ). 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. ( Code Sec. 408(d)(3)(I) ).

Automatic waiver for failures caused by financial institution error. IRS says that 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 60-day 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 60-day 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. ( Rev Proc 2003-16, 2003-4 CB 359, Sec. 3.03 )

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, 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. ( Rev Proc 2003-16, Sec. 3.01 , Rev Proc 2003-16, Sec. 3.02 ).

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 himself with enough time to fix any problems that surface (e.g., rollover to a non-Roth-IRA account) before expiration of the 60-day period.

One-year-wait period. A tax-free rollover from an IRA into another IRA may be made only once a year (a limited exception applies for payouts 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. ( Code Sec. 408(d)(3)(B) ). The one-year rule applies separately to each IRA an individual owns. ( IRS Publication 590, 2004, pg. 22 ).

There are actually two ways in which the one-rollover-per-IRA-per-year rule can be violated:

Illustration: Mr. Baker has two traditional IRAs, IRA-1 and IRA-2. Today, he rolls over assets from IRA-1 into a new IRA-3. He cannot, within the one-year period, either:

- (1) roll over the assets he rolled over into IRA-3 into any other IRA; or
- (2) roll over additional assets from IRA-1 into any other IRA. (IRS Publication 590, 2004, p. 22; Martin, Marshall, (1994) TC Memo 1994-213 , RIA TC Memo ¶94213)

Baker may, however, make a rollover from IRA-2 into IRA-3, or into any other IRA, within one year after the rollover distribution from IRA-1. These are allowable rollovers because Baker hasn't received more than one distribution from either IRA within one year. ( IRS Publication 590, 2004, pg. 22 )

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

- a distribution from a qualified plan that is rolled over to an IRA ( Reg. § 1.402(c)-2 , Q&A 16);
- a direct, trustee-to-trustee transfer to an IRA (Preamble to T.D. 8619, 9/22/95 );
- a conversion of a traditional IRA to a Roth IRA ( Reg. § 1.408A-4 , Q&A 7(c));
- or the recharacterization of a contribution (under Code Code Sec. 408A(d)(6) ). ( Reg. § 1.408A-5 , Q&A 8).

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. ( Rev Rul 78-406, 1978-2 CB 157 ). 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 that applies to IRA rollovers. ( IRS Publication 590, 2004, pg. 18 ).

## **PART II**

Regular contributions to Roth IRAs. For 2005, a taxpayer can make a Roth IRA contribution equal to the lesser of (1) \$4,000 (up to \$4,500 if he is age 50 or older), or 100% of the compensation that's includible in his gross income for that year. The maximum Roth IRA contribution is reduced by amounts contributed to non-Roth IRAs (other than SIMPLE or SEP IRAs), ( Code Sec. 408A(c) ) and is phased out if modified AGI exceeds \$150,000 for joint filers, \$0 for separate filing marrieds, and \$95,000 for others. ( Code Sec. 408A(c)(3) ).

*Timing.* The deadline for establishing and making a contribution to a Roth IRA is the unextended tax return due date for the tax year to which the contributions relate. ( Reg. § 1.408A-3 Q&A-2(b) )

Tax-free rollovers and trustee-to-trustee transfers between Roth IRAs. These transactions generally are subject to the same rules that apply to tax-free rollovers and trustee-to-trustee transfers between traditional IRAs. However, rollovers from retirement plans other than Roth IRAs are disregarded for purposes of the one-year-wait rule for tax-free rollovers. ( Code Sec. 408A(a) , IRS Publication 590, 2004, pg. 57 )

Conversions to Roth IRAs. An amount in a traditional IRA can be converted to a Roth IRA if for the year in which the amount is withdrawn from the traditional IRA, (1) the taxpayer's modified AGI (not counting the taxable amount of the conversion) does not exceed \$100,000, and (2) he isn't a married individual filing a separate return (unless he lived apart from the spouse during the entire withdrawal year). ( Code Sec. 408A(c)(3)(B) ). The \$100,000 limit is figured without regard to required minimum distributions from an IRA. ( Code Sec. 408A(c)(3)(C)(i) ).

*Timing.* An otherwise allowable original conversion from a traditional IRA to a Roth IRA may be made at any time; the one-year waiting period that limits successive rollovers between traditional IRAs does not apply. The conversion can be made via:

- rollover (withdrawal from the traditional IRA and contribution to a Roth IRA within sixty days after the withdrawal);
- direct trustee-to-trustee transfer; or
- redesignation of the account if the traditional IRA and Roth IRA have the same trustee). ( Reg. § 1.408A-4 Q&A-1(b); IRS Publication 590, 2004, pg. 57 )

The income resulting from the conversion is included on the return for the tax year in which funds are transferred or withdrawn from the traditional IRA. However the 10% premature distribution penalty doesn't apply.

Recharacterization of contribution or conversion to Roth IRA. There are three possible types of recharacterizations:

1. A contribution to a Roth IRA may be recharacterized as a contribution to a traditional IRA.
2. A contribution to a traditional IRA may be recharacterized as a contribution to a Roth IRA.
3. A conversion from a traditional IRA to a Roth IRA may be recharacterized (that is, reversed or cancelled out). The taxpayer treats the conversion as if it had never been made by transferring the converted amount (plus earnings, or minus losses) from the Roth IRA back to a traditional IRA via a trustee-to-trustee transfer. ( IRS Publication 590, 2004, pg. 26 )

For recharacterization purposes, a distribution from a traditional IRA that's received in one year and timely rolled over to a Roth IRA in the next year is treated as a contribution to the Roth IRA in the year of the distribution from the traditional IRA. ( IRS Publication 590, 2004, pg. 26 )

*Timing.* Ideally, a recharacterization should be made by the due date (plus extensions) of the taxpayer's return for the affected year, and reflected on the return for that year.

However, a taxpayer can make a recharacterization even after he has filed his return for the year for which a traditional or Roth IRA contribution or conversion to a Roth IRA was made. He can make the recharacterization within 6 months of the unextended due date of his return for the year in which he made the traditional or Roth IRA contribution or conversion to a Roth IRA. Thus, for example, a contribution to a traditional IRA in 2004 may be recharacterized as a contribution to a Roth IRA as late as Oct. 17, 2005. A taxpayer that wants to make a recharacterization after he has filed the return for the affected year must file an amended return reflecting the transfer, and write "Filed pursuant to section 301.9100-2" on the amended return. ( Ann. 99-104, 1999-2 CB 555 ; Instructions to Form 8606 (2004), p. 3 )

Reconversions. A person who converted an amount from a traditional IRA to a Roth IRA may not only transfer the amount back to a traditional IRA in a recharacterization, but may later reconvert that amount from the traditional IRA to a Roth IRA, and, under certain circumstances, have his resulting income fixed at the time of the reconversion.

*Timing.* A taxpayer who converts or has converted an amount from a traditional IRA to a Roth IRA and then transfers that amount back to a traditional IRA by way of a recharacterization can't reconvert that amount from the traditional IRA to a Roth IRA before the beginning of the tax

year following the tax year in which the amount was converted to a Roth IRA or, if later, the end of the 30-day period beginning on the day on which the IRA owner transfers the amount from the Roth IRA back to a traditional IRA by way of a recharacterization. This timing rule applies regardless of whether the recharacterization occurs during the tax year in which the amount was converted to a Roth IRA or the following tax year. ( Reg. § 1.408A-5 , Q&A 99(a)(1)).

Observation: This rule prevents a taxpayer from recharacterizing a Roth IRA as a traditional IRA if the market value of the IRA has been substantially reduced, e.g., because of a sharp decline in the market value of stocks held in the IRA, and then immediately reconverting to a Roth IRA to take advantage of the lower market value in determining the income to be reported from the conversion.

If you have any questions about the above information and how it affects your personal tax situation, please give me a call.

Cordially

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