

# IRAS WITH HAIR



*What to do with an IRA that has a shady past...*

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## SUMMARY CONTENTS

INTRODUCTION .....	4
I. HAIRY SCENARIOS: YOUR CLIENT’S FACTS .....	5
II. THE CHUTES: THE TAX CODE’S PUNISHMENTS .....	18
III. THE “LADDERS”: WAYS TO FIX THINGS .....	29
IV. THINGS YOU NEED TO KNOW TO APPLY THE PRECEDING PARTS .....	46

Most of the material in this Seminar Outline is excerpted from the 7<sup>th</sup> ed. (2011) of the book *Life and Death Planning for Retirement Benefits* (Ataxplan Publications) by Natalie B. Choate. The book may be ordered by calling 800-247-6553, or on line at [www.ataxplan.com](http://www.ataxplan.com), for \$89.95 plus shipping. All rights reserved. The text, especially the “Where to read more” paragraph at the end of each section, contains cross references to portions of the book (indicated by the “¶” symbol) that provide further explanation of topics that are touched on but not discussed in this outline.

## Detailed Table of Contents

Abbreviations and Symbols Used in this Seminar Outline .....	4
Warning: Topics Not Covered in this Outline .....	4
<b>INTRODUCTION</b> .....	<b>4</b>
<b>I. HAIRY SCENARIOS: YOUR CLIENT’S FACTS</b> .....	<b>5</b>
☛1.1 Attempted Roth Conversion of the MRD .....	5
☛1.2 Other Ineligible Purported Roth Conversions .....	6
☛1.3 Problems in Recharacterizing a Roth IRA Conversion .....	6
A. The Roth converter dies after the conversion .....	6
B. Transferring the wrong amount .....	7
C. Transferring to the wrong plan .....	7
D. Using 60-day rollover instead of trustee-to-trustee transfer .....	7
☛1.4 Transferring Funds from a Roth IRA to a NonIRA Plan .....	8
☛1.5 Missing the 60-day Rollover Deadline .....	9
A. First-time homebuyer .....	9
B. Disaster-based extensions .....	10
C. Qualified reservist distribution .....	10
D. One-year deadline for certain financial institution errors .....	10
E. Frozen deposits .....	10
☛1.6 Rolling over the Wrong Asset .....	10
☛1.7 IRA-to-IRA Rollovers: One-Per-12-Months Rule .....	11
☛1.8 Nonspouse Beneficiary Rollover Mistakes with Inherited Benefits .....	12
A. Attempted 60-day rollover .....	13
B. Direct transfer to inherited IRA by ineligible beneficiary .....	13
C. “Roth conversion” of inherited IRA .....	13
D. Direct transfer into beneficiary’s own IRA .....	14
☛1.9 Missing the MRD .....	14
☛1.10 Investment Mistakes and Problems .....	15
A. Direct ownership of “IRA” assets (no custodian) .....	15
B. Unrelated Business Taxable Income .....	15
☛1.11 Keogh Plans with Mold .....	16
<b>II. THE CHUTES: THE TAX CODE’S PUNISHMENTS</b> .....	<b>18</b>
☛2.1 Failed Conversions (Failed Roth Conversions) .....	18
☛2.2 Penalty for Excess IRA Contributions .....	19
☛2.3 Deemed Distributions .....	20
A. Pledging an IRA as security for a loan .....	21
B. Other assignments, pledges, or transfers .....	21
C. IRA acquires collectible .....	22
☛2.4 Plan Loan Problems .....	22

☛2.5	Other “Unintended Distributions”	24
☛2.6	Punishments for Failure to Distribute the MRD	24
☛2.7	10 Percent Penalty for Early Distribution [topic not covered in this Outline]	26
☛2.8	Prohibited Transaction with IRA	27
<b>III.</b>	<b>THE “LADDERS”: WAYS TO FIX THINGS</b>	<b>29</b>
☛3.1	Reversing IRA Contributions: Corrective Distributions	29
A.	Deadline for a corrective IRA distribution	29
B.	Income attributable to returned IRA contribution	30
C.	No deduction taken	30
D.	Income tax and 10 percent penalty treatment	30
E.	Effect on six percent penalty	31
F.	Corrective distribution example	31
☛3.2	Quasi-Corrective Distributions	32
☛3.3	Excess IRA Contributions, cont.: Late return or “Absorption”	32
☛3.4	Rollovers: The Miracle Cleanup Machine	34
☛3.5	Hardship Waiver of the 60-day rollover deadline	36
☛3.6	Recharacterization of an IRA contribution	40
	5.6.01 Which IRA contributions may be recharacterized	40
	5.6.03 How to recharacterize certain IRA/Roth IRA contributions	41
	5.6.04 Partial recharacterizations	42
	5.6.07 Same-year and immediate reconversions banned	42
☛3.7	Missing the deadline for recharacterization	43
☛3.8	Getting out from under the Penalty for Missed MRD	43
☛3.9	The Law of the 1099	45
☛3.10	Sue somebody!	46
<b>IV.</b>	<b>THINGS YOU NEED TO KNOW TO APPLY THE PRECEDING PARTS</b>	<b>46</b>
☛4.1	When the Deadline Is: Due Date Including Extensions	46
☛4.2	How to Compute Earnings on Returned or Recharacterized Contributions	48
☛4.3	“Regular contribution” versus “rollover contribution”	49
☛4.4	“60-day rollover” versus “trustee-to-trustee transfer”	50
	Appendix A: Recommended Publications	51
	Appendix B: People Mentioned in this Outline	52

## Abbreviations and Symbols Used in this Seminar Outline

- ¶ Refers to a section of the author’s book *Life and Death Planning for Retirement Benefits* (7<sup>th</sup> ed. 2011); see cover page.
- § Refers to a section of the Code unless otherwise indicated.
- ☛ Refers to a section of this Seminar Outline.

In the following list of abbreviations, the symbol “¶” indicates the section of the author’s book *Life and Death Planning for Retirement Benefits* (7<sup>th</sup> ed. 2011) that provides a complete definition of the term in question.

Code	Internal Revenue Code of 1986, as amended through March 24, 2011.
DOL	Department of Labor.
EGTRRA	The Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. 107-16).
ERISA	Employee Retirement Income Security Act of 1974.
IRA	Individual retirement account or individual retirement trust under § 408 or § 408A.
IRS	Internal Revenue Service.
MRD	Minimum Required Distribution. See ☛1.9.
PLR	IRS private letter ruling.
PT	Prohibited transaction.
QRP	Qualified Retirement Plan. ¶ 8.3.12.
RBD	Required Beginning Date. ¶ 1.4.01.
Reg.	Treasury Regulation.
Roth IRA	A Roth IRA established in accordance with § 408A of the Code.
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 also does not cover the 10 percent penalty on early distributions (§ 72(t)).

## INTRODUCTION

The world of IRA mistakes is like the children’s game “Chutes and Ladders.” Your client “A” tried to roll over his minimum required 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 minimum required distribution from the IRA she inherited...she tumbles down the “missed MRD” 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 MRD. “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. HAIRY SCENARIOS: YOUR CLIENT’S FACTS

### ☛1.1 Attempted Roth Conversion of the MRD

A minimum required distribution (MRD) cannot be “converted” to a Roth IRA. That’s because a Roth conversion is considered a rollover, and must meet many of the requirements of a rollover; an MRD is not an eligible rollover distribution. § 408(d)(3)(E). (Basically a Roth conversion is a taxable rollover.) What’s more, the first distribution of the year is always the MRD.

**Bogey Example:** In 2011, Bogey turns age 73. He owns an IRA that was worth \$1 million on 12/31/2010 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 MRD (\$40,485.83) for 2011 prior to doing the Roth conversion. What’s the problem and what’s the remedy?

The rollover/Roth conversion is valid as to the \$959,514.17 in excess of the MRD. However, the conversion is a **failed conversion** as to the \$40,485.83 MRD that was not eligible to be converted. Reg. § 1.408A-8, A-1(b)(4). 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 2011 MRD (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 MRD (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”), he has an excess IRA contribution problem. 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 of *Life and Death Planning for Retirement Benefits* (7<sup>th</sup> ed. 2011). For the rules that the MRD cannot be converted, and that the first distribution of the year is the MRD, see ¶ 2.6.03.

## ❖1.2 Other Ineligible Purported Roth Conversions

It shouldn't be common but it is: 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. Here is how it can happen 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.
- ✓ 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 (subsection 5.6.07).

In all 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 can be useful in reversing an undesired 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 the decedent died prior to the deadline for recharacterizing his Roth conversion; see ❖3.7.

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 estate is 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 “mechanical” 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*