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ESTATE PLANNING LEGAL ALERT

IRA Rollover Rules: A "Bait & Switch"?

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Many IRA owners may choose to rely upon the advice of their financial institution or wealth management advisor or choose to look up information and guidance on the IRS' website when navigating the pitfalls of often confusing and rarely understood rules of the Internal Revenue Code ("IRC"), and the equally complex regulations that are designed to explain the IRC.

Unfortunately, such reliance or self-help can often result in an understatement of income taxes and the penalties and interest that often accompany an IRS audit.

For years many IRA owners have been under the misguided belief that a person with more than one IRA could make a rollover contribution of assets from each IRA once within a one year period. The IRS nurtured that understanding by issuing Publication 590, which essentially said as much. Yet, the U.S. Tax Court recently turned that assumption on its head in its decision of *Bobrow v Commissioner*, T.C. Memo 2014-21, Docket No 7022-11 (January 28, 2014). The unfortunate IRA owners were subjected to thousands of dollars of back taxes, a 10% early withdrawal penalty and a 20% penalty for substantially understating their income tax liability.

Generally, distributions from a non-Roth IRA are taxable in a person's gross income. However, the IRC § 408(d)(3)(A) allows the owner of an IRA to take money out of one IRA without incurring any liability for income tax, so long as the money is deposited into another IRA or similar qualifying retirement account within 60 days. This is also the primary way to deposit large amounts of savings in excess of the annual IRA contribution limits. These distributions are referred to as "rollover contributions."

However, to reduce the amount of transfers and limit unnecessary shifting of assets between IRA's, IRC § 408(d)(3)(B) provides:

> This paragraph [allowing rollover contributions] does not apply to any amount described in subparagraph (A)(i) received by an individual **from an individual retirement account** or individual retirement annuity **if** at any time during the **1-year** period ending on the day of such receipt such individual **received any other amount described in that subparagraph from an individual retirement account** or an individual retirement annuity which was **not includible in his gross income** because of the application of this paragraph.

The IRS produced Publication 590 to indicate that it interpreted this statute to mean that, for each IRA a person owns, that person may make a tax-free rollover contribution from or to each account once per year. IRS Publication 590 is still available on the IRS website, and provides an example of how the one year limitation for rollover contributions in IRC § 408(d)(3)(B) should be applied. Publication 590 provides:

> You have two traditional IRAs, IRA-1 and IRA-2. You make a tax-free rollover of a distribution from IRA-1 into a new traditional IRA (IRA-3). You cannot, within 1 year of the distribution from IRA-1, make a tax-free rollover of any distribution from either IRA-1 or IRA-3 into another traditional IRA.
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> However, the **rollover from IRA-1 into IRA-3 does not prevent you from making a tax-free rollover from IRA-2 into any other traditional IRA.** This is because you have not, within the last year, rolled over, tax free, any distribution from IRA-2 or made a tax-free rollover into IRA-2.

The IRS took the position that for each IRA owned by a taxpayer, the taxpayer may make a rollover contribution either into or out of that IRA once within a twelve month period.

Despite the IRS' own interpretation of the IRC, the IRS challenged a husband and wife's attempted rollover contributions. In *Bobrow v Commissioner*, the Tax Court held that IRC § 408(d)(3)(B) allows only one rollover distribution per taxpayer, in any one year period, regardless of the number of different IRAs the taxpayer owns.

While the facts in *Bobrow* are distinguishable from the example provided in Publication 590, the Tax Court's reasoning clearly establishes a window of opportunity for the IRS to challenge many more rollover contributions in the near future where the taxpayers are making several rollover contributions from multiple IRAs in the same twelve month period. The implications of the *Bobrow* decision are serious. Not only could a taxpayer incur additional income tax liability, but he or she may very well be subjected to the infamous 10% penalty for early withdrawal and a penalty for understating his or her income of 20% or more (don't forget to add the interest owed on the unpaid tax and penalties).

Until further guidance from the IRS, any person who advises or contemplates a multiple IRA rollover contribution transaction should seriously consider the potential negative consequences of an unfavorable review by the IRS.

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