



“Borrowing” from Your IRA—A Variant on Russian Roulette
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Rollovers and “Borrowing” from an IRA

Many taxpayers ask their adviser about a technique they’ve heard about for borrowing from their IRA to handle short term cash flow needs. Of course, as we know, what they are talking about is taking a cash distribution from their IRA and then paying those funds back into an IRA within 60 days, but making use of that cash in the interim. While the technique appears to “work” if all of the mechanical rules are met¹, there are significant risks if anything is fouled up along the way that clients need to be aware of.

Rollover Mechanics

The basic rules for a rollover are found at §408(d)(3). The basic rule for a rollover is found at §408(d)(3)(A) which provides:

408(d)(3)(A) IN GENERAL. -- Paragraph (1) does not apply to any amount paid or distributed out of an individual retirement account or individual retirement annuity to the individual for whose benefit the account or annuity is maintained if --

¹ The author is not sure that the IRS might not be able to argue that if the intent were to “borrow” the money and not just effect a transfer of funds, that the taxpayer truly did not engage in a rollover transaction as Congress intended. That said, they have not asserted such a position and it certainly seems they would need a very sympathetic judge to get a ruling in their favor—but if the facts were bad enough I suppose it’s possible that might happen. Remember we always face the problem that bad facts lead to bad law in decisions, so a bad facts case could create a broad intent based ruling.

(i) the entire amount received (including money and any other property) is paid into an individual retirement account or individual retirement annuity (other than an endowment contract) for the benefit of such individual not later than the 60th day after the day on which he receives the payment or distribution; or

(ii) the entire amount received (including money and any other property) is paid into an eligible retirement plan for the benefit of such individual not later than the 60th day after the date on which the payment or distribution is received, except that the maximum amount which may be paid into such plan may not exceed the portion of the amount received which is includible in gross income (determined without regard to this paragraph).

For purposes of clause (ii), the term "eligible retirement plan" means an eligible retirement plan described in clause (iii), (iv), (v), or (vi) of section 402(c)(8)(B).

However, there is a “once a year” restriction found in §408(d)(3)(B) that provides:

408(d)(3)(B) LIMITATION. --This paragraph 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.

A taxpayer does not need to rollover his/her entire distribution—a partial IRA rollover is allowed, with only the part actually placed back into an IRA within 60 days² eligible for exclusion from income (§408(d)(3)(D)).

The IRA in question cannot be an “inherited IRA” as defined in this provision (§408(d)(3)(C)) and the distribution being rolled over cannot be a required distribution (§408(d)(3)(E)).

Waiver of 60 Day Rule

Until recently, the IRS had no specific authority to waive a violation of the 60 day requirement set in the Code. So that means a taxpayer who failed to get the funds back into an IRA within 60 days could not effect a rollover and had to include the entire distribution in income, plus pay any early distribution tax that might be due. The IRS was granted statutory authority to waive such penalties at the IRS’s discretion. The provision is found in §408(d)(3)(I):

408(d)(3)(I) WAIVER OF 60-DAY REQUIREMENT. --The Secretary may waive the 60-day requirement under subparagraphs (A) and (D) where the failure to waive such requirement would be against equity or good conscience, including casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement.

² Or, if a waiver of the 60 day period is granted as described below, one subject to the waiver.

Since this provision has become law, the IRS has issued a number of rulings, both favorable and unfavorable under this provision. The IRS has generally not been very understanding of taxpayers looking to “borrow” from the IRA, though they have been quite willing to waive the time period for clients whose motivation was truly to simply move funds from one retirement account to another. The IRS’s sympathy was not garnered even in the case, noted below, where extraordinary circumstances combined to foil what appeared to be “no risk” strategy where the funds would be back in the IRA well within 60 days.

Hurricane Frances, the Home Purchase and the IRA

(IRS Letter Ruling 200544022, 11/7/05) An individual took a distribution from his IRA in order to provide short term funds for the purchase of a new home. The taxpayer intended to restore the funds to the IRA within the 60 day window allowed once a year for a rollover of a distribution from an IRA account, using funds to be received from a home equity loan he planned to obtain on the new home. One week after the distribution was made, the taxpayer submitted the paperwork to obtain the home equity loan.

Before the loan was approved and the funds distributed, the taxpayer’s home was severely damaged and declared uninhabitable by Hurricane Frances. Due to this change in circumstance, the lender was unable to complete the loan request and did not finally receive these loan proceeds until nearly nine months after the funds had been distributed from the IRA. No funds were redeposited in the IRA during the 60 day period or the extended period granted for rollovers in process under the special tax relief granted by the IRS for that hurricane, which required rollovers to be completed by December 30, 2004.

The taxpayer asked for permission to redeposit these funds into the IRA under these circumstances. The IRS turned down this request, noting “The Committee Report describing legislative intent indicates that Congress enacted the rollover provisions to allow portability between eligible plans including IRAs. In general using a distribution as a short term loan to cover personal expenses is not consistent with the intent of Congress to allow portability between eligible plans and under those circumstances, the failure to waive the 60-day requirement would not be against equity or good conscience where a taxpayer is not able to redeposit the funds within the 60-day period.”

Many clients have heard from various financial sources that they can “borrow” from their IRA, and in fact will refer to the 60 day rollover rule in just that fashion. What this ruling makes clear is that the use of funds in those fashion requires strict adherence to the mechanical rules of the law, and taxpayers cannot expect to receive any relief from the IRS in these cases if the rollover is not completed. Clients who wish to use this mechanism should be warned that they must assume no excuse is going to be deemed adequate for not complying strictly with all requirements in these cases.

Advisers who discuss this option with a client need to make clear that no sob story, no matter how compelling, is going to work to allow them to return the funds to the IRA account if it is

clear their intent at the time of the distribution was to borrow from the IRA. Advisers who fail to make this clear to clients who ask about doing this or, worse, suggest this strategy to clients who had not heard about it, risk having clients who will look to the adviser to “make them whole” for both the taxes paid and the loss of future tax deferrals on these funds. Prudence suggests you be sure that you do not become the “guarantor” of the success of the client’s strategy in these cases.

While the odds are overwhelming in many cases that the client will get the funds back into the IRA in time, this ruling proves that even plans that appear to be “sure things” can go wrong—and if you are involved in enough of them, one time the chamber will have a bullet in it when it comes time to pull the trigger. Our job is to warn the client about the game they are playing.

Private Letter Ruling 200544022 Text

DEPARTMENT OF THE TREASURY INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

AUG 10 2005

Uniform Issue List: 408.03-00

Legend:

Taxpayer A =

Amount D =

Broker B =

Mortgage Company A =

IRA X =

State F =

Dear [Redacted Data]:

In letters dated September 16, 2004, and December 23, 2004, you requested a waiver of the 60-day rollover requirement contained in section 408(d)(3) of the Internal Revenue Code (the Code).

The following facts and representations have been submitted under penalty of perjury in support of the ruling requested:

On July 22, 2004, Taxpayer A, through Broker B, withdrew Amount D from IRA X, an individual retirement account described in Code section 408(a), which was then used for the purchase of his new home in State F. Taxpayer A informed Broker B that it was his intent to redeposit Amount D into an IRA within 60 days of the withdrawal using funds he would receive from closing an equity loan on his new home in State F. On or about July 29, 2004, Taxpayer A completed the paperwork necessary to apply for a home equity line

of credit at Mortgage Company A on his new home. Subsequently, a hurricane devastated the city where his new home is located and severely damaged Taxpayer A's new home. As a result Taxpayer A's home was declared uninhabitable and Mortgage Company A, which was processing Taxpayer A's request for a home equity line of credit, was unable to complete the loan process. Taxpayer A did not receive the proceeds of his home equity line of credit until April 13, 2005.

On September 10, 2004, the Internal Revenue Service issued a News Release, IR-2004-115, in which it announced special tax relief for [Redacted Data] taxpayers in the Presidential Disaster Area that was struck by Hurricane Frances on September 3, 2004 (FEMA-1545-DR). The special relief gave affected taxpayers until December 30, 2004, to perform certain time-sensitive actions described in Treasury Regulation 301.7508A-1(c)(1) which includes the making of a rollover under section 408(d)(3). Taxpayer A was an affected taxpayer located in the Presidential Disaster Area and accordingly had until December 30, 2004, to complete the rollover. As set forth above, Taxpayer A did not receive the proceeds of his home equity line of credit until April 13, 2005.

Based on the facts and representations, you request that the Internal Revenue Service waive the 60-day rollover requirement with respect to the distribution of Amount D because the failure to waive such requirement would be a hardship and against equity or good conscience.

Section 408(d)(1) of the Code provides that, except as otherwise provided in section 408(d), any amount paid or distributed out of an IRA shall be included in gross income by the payee or distributee, as the case may be, in the manner provided under section 72 of the Code.

Section 408(d)(3) of the Code defines, and provides the rules applicable to IRA rollovers.

Section 408(d)(3)(A) of the Code provides that section 408(d)(1) of the Code does not apply to any amount paid or distributed out of an IRA to the individual for whose benefit the IRA is maintained if-

(i) the entire amount received (including money and any other property) is paid into an IRA for the benefit of such individual not later than the 60th day after the day on which the individual receives the payment or distribution; or

(ii) the entire amount received (including money and any other property) is paid into an eligible retirement plan (other than an IRA) for the benefit of such individual not later than the 60th day after the date on which the payment or distribution is received, except that the maximum amount which may be paid into such plan may not exceed the portion of the amount received which is includible in gross income (determined without regard to section 408(d)(3)).

Section 408(d)(3)(B) of the Code provides that section 408(d)(3) does not apply to any amount described in section 408(d)(3)(A)(i) received by an individual from an IRA if at any time during the 1- year period ending on the day of such receipt such individual

received any other amount described in section 408(d)(3)(A)(I) from an IRA which was not includible in gross income because of the application of section 408(d)(3).

Section 408(d)(3)(D) of the Code provides a similar 60-day rollover period for partial rollovers.

Section 408(d)(3)(I) of the Code provides that the Secretary may waive the 60-day requirement under sections 408(d)(3)(A) and 408(d)(3)(D) of the Code where the failure to waive such requirement would be against equity or good conscience, including casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement. Only distributions that occurred after December 31, 2001, are eligible for the waiver under section 408(d)(3)(I) of the Code.

Revenue Procedure 2003-16, 2003-4 I.R.B. 359, (January 27, 2003) provides that in determining whether to grant a waiver of the 60-day rollover requirement pursuant to section 408(d)(3)(I), the Service will consider all relevant facts and circumstances, including: (1) errors committed by a financial institution; (2) inability to complete a rollover due to death, disability, hospitalization, incarceration, restrictions imposed by a foreign country or postal error, (3) the use of the amount distributed (for example, in the case of payment by check, whether the check was cashed); and (4) the time elapsed since the distribution occurred.

The information presented by Taxpayer A indicates that Taxpayer A took a distribution in order to purchase a house in State F. Taxpayer A intended to redeposit Amount D using the proceeds from an equity loan on his new house.

It appears from the facts that Taxpayer A used his IRA distribution in a transaction that in essence, amounts to a short-term interest free loan. The Committee Report describing legislative intent indicates that Congress enacted the rollover provisions to allow portability-between eligible plans including IRAs. In general using a distribution as a short term loan to cover personal expenses is not consistent with the intent of Congress to allow portability between eligible plans and under those circumstances, the failure to waive the 60-day requirement would not be against equity or good conscience where a taxpayer is not able to redeposit the funds within the 60-day period.

Thus, the Service will not grant any extension to the 60-day rollover period of Code section 408(d)(3)(A)(1), as extended by appropriate Presidential Disaster Relief provisions in this case.

This letter is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

If you wish to inquire about this ruling, please contact [Redacted Data] I.D. # [Redacted Data] at [Redacted Data]. Please address all correspondence to SE:T:EP:RA:T3.

Sincerely yours,

Frances V. Sloan, Manager Employee Plans Technical Group 3

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Enclosures: Deleted copy of letter ruling Notice of intention to Disclose