IRS EASES RETIREMENT ACCOUNT ROLLOVER NIGHTMARES BUT TAXPAYERS NEED TO REMAIN CAUTIOUS

The IRS is easing some of the nightmare financial consequences of mishandled tax-free rollovers from individual retirement accounts and retirement plans—but taxpayers need to remain vigilant to avoid unnecessary taxes and penalties.

A rollover occurs when you take money out of either an IRA or qualified retirement plan such as a 401(k) or 403(b) and move it into another IRA or qualified plan—or return it to the IRA or plan you took it from.

The rollover is free of tax, and free of the 10 percent early withdrawal penalty (which would apply if you are younger than age 59 1/2), as long as you follow two rules: (1) You must complete the rollover within 60 days of the initial withdrawal; (2) you can do only one rollover from each account within a one-year period starting from the day of the withdrawal. If you fail to complete the rollover within 60 days of the withdrawal, you risk owing income taxes and penalties, though that's where the IRS is carving out some exceptions.

Before we get to the exceptions, though, realize that you can avoid rollover problems by doing what's called a direct trustee-to-trustee transfer. That's where the money is moved directly between the financial institutions without you ever personally controlling the funds at any point. With this process, you don't face the 60-day issue or the once-in-a-year rule.

Direct transfers also avoid another major problem with some rollovers. In cases where you take money out of a qualified retirement plan (but not an IRA), a mandatory 20 percent of the withdrawal is withheld for taxes. The withholding will be refunded when you file your next tax return as long as you make up that 20 percent with new money in time to complete the full rollover within 60 days. Otherwise, the withheld 20 percent will be treated as a taxable withdrawal!

While direct transfers are usually the preferred method, you may still end up, for a variety of reasons, making a rollover. So what happens if there's a problem and you fail to complete the rollover within 60 days? Are you automatically stuck with the taxes and possible penalties? That depends on the cause of the problem.

Until 2001, the 60-day rollover rule was pretty inflexible. Other than rollovers involving military personnel in combat or taxpayers caught up in a presidentially declared disaster area, exceptions were rare. In the 2001 tax act, Congress gave the IRS more leeway in waiving the 60-day rule. Since then, the IRS has issued a Revenue Procedure and numerous private letter rulings (PLRs) that provide some guidance for when and how exceptions can be made. (Technically, a PLR applies only to the taxpayer involved, though tax experts generally agree they provide insight into IRS thinking on the issue.)

So what exceptions has the IRS allowed? If a financial services institution involved in handling the rollover makes an error, the taxpayer is typically off the hook. Perhaps the institution gives the taxpayer erroneous advice (in one case, the taxpayer was told the rollover period was 90 days, not 60), mistakenly distributes the funds to the wrong account, or fails to follow the account holder's instructions. If the taxpayer can show such failures, the IRS has been sympathetic about waiving the 60-day rule. The same relief has applied where the plan administrator has made an error.

The IRS has granted exceptions to taxpayers who failed to make timely rollovers due to physical problems or mental problems, such as confusion or memory loss resulting from an accident. If the account owner dies before completing the rollover, an exception also might be made.

The IRS has been far less willing to grant relief where the taxpayer took out money as a short-term loan instead of with the objective of rolling it into another account, though even here the IRS has made exceptions. Thus, taxpayers must be very careful of the circumstances if they hope to gain IRS relief.

To obtain a waiver, taxpayers usually must request a private letter ruling, though in the case where it is the sole fault of the financial institution, they can automatically get relief without requesting a PLR.

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