ADVISORS JOURNAL (July 2010, Current Comment 10-33)

Waiver of the 60-Day Tax-free Rollover Requirement: Survey of Letter

Taxation of a distribution from a qualified plan can be deferred through the use of a tax-free rollover into another qualified plan, individual retirement account (IRA) or individual retirement annuity [I.R.C. §402(c)(1)]. A tax-free rollover may be accomplished by either receipt of the distribution and reinvestment in another qualified plan or IRA within 60 days; or direct transfer to the other qualified plan.

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") added new I.R.C. § 408(d)(3)(I) to permit the IRS to waive the 60-day requirement when "equity or good conscience" required. Revenue Procedure 2003-16 set forth the IRS's guidance for implementing this "hardship" exception, effective for distributions after December 31, 2001.

Rev. Proc. 2003-16

According to Rev. Proc. 2003-16, the Service will grant a waiver of the 60-day requirement when failure to do so would be against equity or good conscience, including casualty, disaster or other events beyond the reasonable control of the taxpayer. The factors considered include

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.

Survey of Letter Rulings

Subsequent letter rulings have gone well beyond the examples of hardship situations given in the Congressional Conference Committee Report to EGTRRA, such as during a period in which a distribution in the form of a check was not cashed, or for errors committed by a financial institution, or in cases of inability to complete a rollover due to death, disability, hospitalization, incarceration, restrictions imposed by a foreign country or postal error [H.R. Rep. No. 84, 107th Cong., 1st Sess. 252 (2001)]. For example, PLR 200327064, the first occasion on which the IRS granted a waiver under §408(d)(3)(I), involved a simple case of misappropriation by the taxpayers' investment manager. A later series of letter rulings (PLR 200401020; PLR 200401023; PLR 200401024 and PLR 200401025) granted waivers, respectively, for a bank's erroneous withdrawal of funds from the taxpayer's IRA rather than the non-tax-favored account he specified; an attempted rollover that failed because the transferee bank erroneously opened a CD rather than an IRA; a taxpayer's failure to complete a rollover because he was institutionalized during the 60-day period; and a withdrawal made by a taxpayer with Alzheimer's whose daughter provided a medical declaration that her mother was incapable of understanding the consequences.

In PLR 200410027, the IRS went further than ever, granting a waiver to a hearing-impaired taxpayer who misunderstood an explanation of what he thought were rollover documents because he was not wearing his hearing aids.

These letter rulings, taken together, show that the Service seems committed to applying the relief afforded by § 408(d)(3)(I) liberally. In fact, it is becoming easier to ask under what circumstances the IRS will deny a waiver of the 60-day period. The examples are few. In PLR 20042803, the taxpayer received a notice of intent to levy from the IRS. The notice applied to amounts held in IRAs. The taxpayer made a withdrawal from his IRA in an attempt to avoid the levy. The IRS sent and then withdrew a notice of levy; thereafter, the taxpayer requested a waiver so that his redeposit of the amount he withdrew to avoid the levy could be treated as a rollover. The taxpayer, it would seem, was determined to illustrate the famous definition of the term "chutzpah": the quality exhibited by a man who murders his parents and then throws himself on the court's mercy because he's an orphan. Clearly the Service had to deny a waiver.

More problematically, in PLR 200428034, the taxpayer took withdrawals from an IRA in order to cover necessary expenses during a period of unemployment and redeposited them after the 60-day period. Unlike a previous similar case, PLR 200417033, the taxpayer was able to argue that because his financial institution incorrectly told him he could only make one IRA withdrawal per year, he withdrew too much money; the Service allowed a waiver for the amounts he had not spent. The problem with these two letter rulings is not the denial of the waiver: Congress certainly never intended employees to use their retirement funds during periods of unemployment for what the IRS characterizes as interest-free loans. Rather, they highlight the problem that one can take such an "interest-free loan" from one's IRA as long as one redeposits it within 60 days.

In PLR 200502050, the Service was confronted with a situation, alluded to above, in which a taxpayer tried to effectuate a rollover but died before succeeding. In this instance, she tried to effect a trustee-to-trustee transfer but was frustrated by bank error; the bank sent 80% of the funds to the new IRA custodian but withheld the remaining 20%, as is standard with a true rollover. The taxpayer tried to correct the error but could not do so before she died. The executor then deposited the equivalent of the withheld 20% in the second IRA. As explained above, this would have effected a rollover had it happened within the 60-day limit. The executor therefore asked for a waiver, which the IRS granted, holding that under these circumstances the executor could complete the rollover even though this would not usually be the case. Here death and financial institution error, two of the IRS's favorite justifications for granting waivers, combined to virtually compel the result.

Continuing in its sometimes inscrutable way, the IRS issued one of its rare rollover waiver denials in PLR 200508027 (Nov. 30, 2004), in which a widow effected a direct rollover of her husband's retirement account under the misapprehension that the 20 percent withheld represented her entire tax obligation. When she found otherwise and asked for a waiver, the IRS refused, saying that she had signed documents warning her of the consequences of a direct rollover and taken it anyway. This argument, holding the documents against the taxpayer, is probably unprecedented in the rollover waiver decisions, and if consistently applied would likely result in denial of virtually all waiver requests. (To be sure, the IRS could not appeal to its listed criteria; in particular, the taxpayer got accurate advice from the financial institution but did not understand it. But how much worse is this than getting accurate information but not hearing it because you turned off your hearing aid?)

This outcome seems particularly harsh when compared with the IRS's decision two weeks earlier in PLR 200506033. Here, the taxpayer withdrew his entire IRA balance less fees to hold it ready for a first house payment. When the deal fell through, three weeks later, he tried to effect a rollover but was talked out of it when the financial institution advised him, wrongly, that he would be subject to a 10 percent penalty. The IRS held that he would have effected the rollover if not for the bad financial institution advice. However, the bad advice did not prevent the rollover, it merely dissuaded the taxpayer from effecting it. He could have done it if he'd been willing to pay what he believed was the 10 penalty. One can easily see the IRS, in different mood, holding this against him as it held the taxpayer's misunderstanding against her in PLR 200508027.

Does the accumulated experience of rollover waiver letters give us any basis for predicting how likely a particular client's request is to be approved? To some extent: but any particular case is a crapshoot. Nonetheless, some situations are more favorable than others, and allow us to suggest some guidelines.

- Try to bring your case within one of the enumerated factors, especially financial institution error. Cases that would have clearly gone against the taxpayer can be turned around if any kind of "error" can be pinned on the financial institution—even failing to read the taxpayer's mind to inform him of a mistaken belief, as in PLR 200543065 and PLR 200547023. In PLR 200828034, the IRS waived the 60-day rollover requirement for an amount misappropriated by a financial institution employee. Most recently in PLR 201021040 the Service waived the 60-day rollover requirement due to incorrect advice provided by a financial advisor who told taxpayer he had 90 days in which to rollover the distributed amount into another IRA. The taxpayer redeposited the distributed amount 83 days after the distribution.

- Look sympathetic. Family caregiving obligations are not among the factors listed in the statute or regulations. It is not clear in general whether they are matters beyond the taxpayer's reasonable control that would have prevented a rollover—the spirit of the law. Nonetheless, the taxpayer in PLR 200547022 cited the distraction caused by such obligations as the basis for her waiver request, and the IRS granted it. On the other hand, the taxpayer in PLR 200548030, who used part of his distribution to buy a motorcycle, got no sympathy from the IRS.
- Make sure you can replace a short-term distribution in timely fashion. Congress allowed you to use an IRA distribution as a short-term loan, but the IRS has shown implacable hostility toward taxpayers who do so. So if you do this, just be very sure you can complete the rollover in timely fashion.

AUS/Advisors Journal lead author and editor: Robert J. Adler, J.D.