Can an IRA owner complete a 60-day rollover by contributing cash to an IRA instead of the property received in an in-kind distribution?

The short answer is "No".

We have received several calls regarding 60-day rollovers involving in-kind distributions. Surprisingly, we have found that advisors, including CPAs and attorneys, are suggesting to their clients that if they take an in-kind distribution from an IRA, they can contribute cash equal to the fair market value of the property received to the same or another IRA within 60 days and avoid taxation of the distribution.

Unfortunately, following this advice may lead to costly consequences.

It is true that an IRA owner may avoid being taxed on a distribution from an IRA by completing a valid rollover to the same IRA, another IRA or a qualified plan (such as a 401(k) profit sharing plan) within 60 days of receiving the distribution. However, to be a valid rollover, the rollover must consist of the "same property" received in the distribution.

Section 408(d) of the Internal Revenue Code (the "Code") addresses the **Tax Treatment of Distributions** from IRAs. 408(d)(1) reads

> **(1) In General** Except as otherwise provided in this subsection, any amount paid or distributed out of an individual retirement plan shall be included in gross income by the payee or distributee, as the case may be, in the manner provided under section 72.

This means that the general rule is that, unless the Code provides an exception, all distributions from an IRA are taxable.

408(d)(3) [1]provides one such exception - the rollover contribution - and spells out the requirements that must be met.

The requirements for the rollover to be valid are:

- The rollover must be completed within 60-days of the distribution
- The rollover must be made to a valid retirement account (such as an IRA or qualified plan)
- The taxpayer is allowed only one rollover in a 1-year period
- Required minimum distributions may not be rolled over
- Rollovers to inherited IRAs are not allowed
- The rollover must include the same money or property received in the distribution

Advisors and taxpayers who insist that it is permissible to roll over cash instead of the asset (property) received in the distribution typically look at 408(d)(3)(A)(i) and interpret "the entire amount received (including money and any other property)" to mean that if the amount of the distribution, including both cash and property, is $X, then a rollover contribution of $X is permissible, since it is the same amount received in the distribution.

While this is an understandable conclusion, the IRS and the courts have concluded differently. These will be addressed later.

Another code section that advisors and taxpayers may reference is 402(c)(6)(A) which reads

> **(A) Transfer of proceeds from sale of distributed property treated as transfer of distributed property**
> The transfer of an amount equal to any portion of the proceeds from the sale of property received in the distribution shall be treated as the transfer of property received in the distribution.

In short, this means that if you receive a distribution of property, such as stock, from a qualified plan, such as a 401(k) plan, you are permitted to sell the stock and roll over the proceeds from the sale. Note that the Code section is 402 (dealing with qualified employee benefit plans) not 408 (dealing with IRAs). This exception applies only in the case of distributions made from qualified plans. This exception was added to section 402 of the Code in 1978 and no corresponding exception was added for IRAs in Code section 408. Thus, if you received stock in a distribution from an IRA, the Code does not permit you to sell the stock and roll the proceeds over to another IRA or qualified plan.

COURT CASES AND IRS RULINGS

Instructions to Form 1040

The section regarding rollovers on Page 27 of the Form 1040 Instructions is clear. It provides:

Rollovers

Generally, a qualified rollover is a tax-free distribution of cash or other assets from one retirement plan that is contributed to another plan within 60-days of receiving the distribution.

Notice that no reference is made to the "amount" of the distribution or contribution. To be qualified, the cash or assets (not the amount) distributed must be contributed to the other plan.

IRS Publication 590-A

Furthermore, Page 24 of Publication 590-A, *Contributions to Individual Retirement Arrangements (IRAs)*, describing rollovers from one IRA to another, explicitly states:

The same property must be rolled over. If property is distributed to you from an IRA and you complete the rollover by contributing property to an IRA, your rollover is tax free only if the property you contribute is the same property that was distributed to you.

For example, if you receive a convertible note in a distribution from an IRA and you convert the note to an equity position (such as stock) in the company that issued the note, you cannot roll the stock over to another IRA.

On page 26 of that same publication, the IRS states that in regards to rollovers from an employer's plan into an IRA:

***The same property (or sales proceeds) must be rolled over*.** If you receive property in an eligible rollover distribution from a qualified retirement plan you cannot keep the property and contribute cash to a traditional IRA in place of the property. You must either roll over the property or sell it and roll over the proceeds as explained next.

Sale of property received in a distribution from a qualified plan. Instead of rolling over a distribution of property other than cash, you can sell all or part of the property and roll over the amount you receive from the sale (the proceeds) into a traditional IRA. You cannot keep the property and substitute your own funds for property you received.

Note that the IRS provides you can roll over proceeds only for distributions from qualified plans; the section describing rollover from distributions from IRAs does not include a provision for rolling over proceeds or any other property other than the property received in an IRA distribution.

Revenue Ruling 87-77

This revenue ruling addressed the situation in which an employee received a distribution of 10x dollars in cash and 15x dollars' worth of property from a profit sharing plan. The employee contributed the 10x dollars cash received to an IRA, plus an additional 15x dollars of cash representing the fair market value of the property received and retained the original property received in the distribution.

In the ruling, the IRS concluded that the contribution to an IRA of cash representing the fair market value of property received in the distribution was **not** a rollover contribution described in section 402(a) of the Code.

ALBERT LEMISHOW, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

In this Tax Court case, Mr. Lemishow (an accountant) received cash distributions from his two IRAs and his Keogh plan (a qualified plan sponsored by a sole-proprietor). Shortly after receiving the distributions (within 60 days), Mr. Lemishow used the funds from the distributions to purchase stock in a financial company, opened a new IRA and deposited the stock in the new IRA. He did not report any of the distributions on his income tax return.

In its ruling, the court held that "secs. 408(d) and 402(c), I.R.C., both require that a rollover contribution, from a distribution of money, consist only of money." The result is that the contribution of the stock to the new IRA did not constitute a rollover contribution and therefore the distributions were includible in income (i.e., he was taxed on the distributions).

Now, some may conclude that this case deals with a different set of facts in that here a rollover of property follows a distribution of cash whereas the issue at hand involves a distribution of property followed by a rollover of cash.

In explaining his opinion, the judge said "With respect to rollovers, the legislative history repeatedly speaks in terms of 'this same money or property' and "the same amount of money (or the same property)", both for distributions from an IRA and from a qualified plan."

The actual language found in House Report 93-807 reads as follows:

'Tax-free rollovers. – To permit flexibility with respect to the investment of an individual retirement account, the bill provides that money or property may be distributed from an individual retirement account to the person for whose benefit the account is maintained without payment of tax, provided the same money or property is reinvested by the individual within 60 days in another qualifying individual retirement account maintained for this benefit.'

This is reiterated six paragraphs later in the House Report where it addresses rollovers following distributions from qualified plans:

"As with a rollover between individual retirement accounts, the same property (other than money) received from a qualified trust is to be contributed to the retirement account."

CONSEQUENCES OF AN INVALID ROLLOVER

Despite the clear intention of Congress, some will nevertheless choose to liberally interpret 408(d)(3)(A)(i) to permit a rollover of cash following a distribution of property.

You should be aware of the consequences if the IRS disagrees with you. Here are a few to consider:

1. Income tax on the distribution
2. Additional 10% tax on early distributions (if applicable)
3. Penalties for underpayment of taxes
4. Interest on unpaid taxes
5. Additional 6% tax per year on excess contribution (the invalid rollover) to your IRA
6. Possible taxation when the excess contribution is corrected

While 1-4 should come as no surprise, 5-6 are often overlooked and their ramifications are greatly underestimated.

For example, assume that Taxpayer T, who was born on May 30, 1955, retired in 2013 and had no earned income after 2013. T had an IRA with custodian A (IRA A) consisting of publicly traded mutual funds and stocks and a self-directed IRA with custodian B (IRA B) consisting of an interest in a non-publicly traded partnership. The partnership interest had a fair market value of $100,000. The IRA had periodically received capital calls from the general partner. Historically, the IRA was able to pay the capital calls but depleted its cash and could no longer meet the capital calls. T had sufficient personal funds to pay the capital calls so T took an in-kind distribution of the partnership interest on November 18, 2014. On December 12, 2014 T opened another IRA with custodian C (IRA C) and deposited $100,000 in IRA C as a rollover contribution. T filed his 2014 tax return on April 15, 2015 and reported the $100,000 distribution on the return but reported the taxable amount as zero because $100,000 was rolled over within 60 days. T never made after tax contributions to any of his IRAs.

On April 10, 2017, the IRS notified T that his 2014 tax return was being audited. During the audit, the IRS concluded that the $100,000 rollover was not valid because T contributed cash to the IRA instead of the partnership interest received in the distribution. As a result of the audit, the IRS assessed the additional tax before April 15, 2018.

Because the rollover was not valid, the IRS determined that the entire $100,000 was taxable in 2014 and that T owed $$33,000 (assuming that T was in the 33% tax bracket) in income tax. In addition, because T was not age 59 ½ at the time of the distribution, he owed an additional $10,000 due to the early distribution. Also, there is interest of $3,846. Further, because T substantially understated his income tax, the IRS imposed an accuracy related penalty of 20% of underpayment or $6,600 (.20 X $33,000 = $6,600).

To compound the problem, because the $100,000 contributed to IRA C was not a valid rollover, the $100,000 was an excess IRA contribution. Since T was retired and had no earned income after 2013, no part of the $100,000 could be treated as an annual IRA contribution. There is a 6% excise tax due each year that an excess IRA contribution is not corrected. T owed $24,000 in excise taxes ($6,000 for each year 2014 – 2017).

To correct the excess contribution, T took a distribution of $100,000 from IRA C on May 1, 2018. Since T did not correct the excess contribution by October 15, 2015 the correcting distribution was taxed according to the general rules for distributions. The fair market values of IRA A and IRA C on December 31, 2018 were $899,00,000 and $1,000 respectively. T completed Form 8606 and determined that $90,000 of the $100,000 distribution was taxable. Based on as 33% marginal tax bracket, the tax on the distribution was $30,000 (.33 X $90,000).

In review, here are the taxes, penalties and interest incurred:

Income tax on the original distribution	$ 33,000
10% additional tax for early distribution	$ 10,000
Interest on late payment of taxes	$ 3,846
Accuracy related penalty	$ 6,600
Excise tax on excess IRA contribution	$ 24,000
Tax on distribution to correct excess contribution	$ 30,000
Total	$107,446

As you can see, T paid $64,446 more than necessary. If he had not made the invalid rollover contribution, his total payments to the IRS would have been $43,000 instead of $107,446.

CONSEQUENCES OF AN INVALID ROTH CONVERSION

Some advisors have also suggested that the IRA owner can contribute cash to a Roth IRA instead of the property received in the distribution and treat it as a Roth conversion. This would result in an excess Roth contribution and the financial consequences would be the same as those in the above example except that there would be no tax on the distribution to correct the excess Roth contribution.

The taxes, penalties and interest incurred would be:

Income tax on the original distribution	$ 33,000
10% additional tax for early distribution	$ 10,000
Interest on late payment of taxes	$ 3,846
Accuracy related penalty	$ 6,600
Excise tax on excess Roth contribution	$ 24,000
Tax on distribution to correct excess Roth contribution	$ 0
Total	$ 77,446

As you can see, T paid $34,446 more than necessary. If he had not made the invalid Roth conversion, his total payments to the IRS would have been $43,000 instead of $77,446.

We recognize that the issues addressed here may be complicated. Retirement plan law is a highly specialized area of practice. If you have questions about this issue, you may want to consider contacting an attorney who specializes in ERISA law.

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[1] **408(d)(3) Rollover Contribution** An amount is described in this paragraph as a rollover contribution if it meets the requirements of subparagraphs (A) and (B).

(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—

(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).

(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.

(C) Denial of rollover treatment for inherited accounts, etc.

(i) In general In the case of an inherited individual retirement account or individual retirement annuity—

(I) this paragraph shall not apply to any amount received by an individual from such an account or annuity (and no amount transferred from such account or annuity to another individual retirement account or annuity shall be excluded from gross income by reason of such transfer), and

(II) such inherited account or annuity shall not be treated as an individual retirement account or annuity for purposes of determining whether any other amount is a rollover contribution.

(ii)Inherited individual retirement account or annuity An individual retirement account or individual retirement annuity shall be treated as inherited if—

(I) the individual for whose benefit the account or annuity is maintained acquired such account by reason of the death of another individual, and

(II) such individual was not the surviving spouse of such other individual.

(D) Partial rollovers permitted

(i) In general
If any amount paid or distributed out of an individual retirement account or individual retirement annuity would meet the requirements of subparagraph (A) but for the fact that the entire amount was not paid into an eligible plan as required by clause (i) or (ii) of subparagraph (A), such amount shall be treated as meeting the requirements of subparagraph (A) to the extent it is paid into an eligible plan referred to in such clause not later than the 60th day referred to in such clause.

(ii)Eligible plan
For purposes of clause (i), the term "eligible plan" means any account, annuity, contract, or plan referred to in subparagraph (A).

(E) Denial of rollover treatment for required distributions
This paragraph shall not apply to any amount to the extent such amount is required to be distributed under subsection (a)(6) or (b)(3).