January 2, 2015

A WORD OF CAUTION ON SHORT TERM IRA WITHDRAWALS

Dear Clients and Friends:

Many IRA owners withdraw funds from their IRA accounts for short-term purposes. The owner then uses subsequent income to restore funds to the IRA. If the restored contribution is made within sixty days of the withdrawal, the withdrawal may be tax-free. The recent Tax Court decision in Bobrow v. Commissioner, T.C. Memo 2004-21, is a cautionary tale that limits the availability of this strategy.

Mr. Bobrow had two separate IRA accounts: IRA #1 and IRA #2. He received two distributions totaling $65,064 in cash from IRA #1. Approximately two months later he withdrew an additional $65,064 in cash from IRA #2. Four days after the withdrawal from IRA #2, he contributed $65,064 in cash to IRA #1. Mr. Bobrow then contributed $65,064 in cash to IRA #2 within sixty days of the withdrawal from that IRA.

Mr. Bobrow contended that each IRA withdrawal and contribution is determined independently of any other IRA rollover under Internal Revenue Code section 408(d)(3)(B).

The IRS took a contrary position. The government argued that Mr. Bobrow could only roll over one withdrawal from all of his IRAs in a twelve month period. The second $65,064 withdrawal was a taxable transaction regardless of the re-contribution of funds.

The Tax Court agreed with the IRS. Mr. Bobrow was limited to one rollover and he could not apply that limitation separately to each of his IRAs. Mr. Bobrow's transfers to and from his IRA accounts occurred within a single twelve month period so that he could only exclude one $65,064 withdrawal from income tax. The second withdrawal was taxable despite the later contribution of equivalent funds, and was subject to interest and penalties.

The Tax Court decision was a surprise because it was contrary to long standing IRS publications and proposed regulations. For over thirty years taxpayers have relied on that published guidance as authority that the limitation of one rollover within a twelve month period is determined separately for each IRA. Mr. Bobrow asked that the Tax Court reconsider its decision because of that contrary position. Tax Court rules allow modification of an issued decision if it represents "substantial error".

The court declined to reconsider its decision because neither side had raised the issue of prior published guidance at trial. The government responded that its attorneys were unaware of proposed regulations until Mr. Bobrow filed for reconsideration, and admitted that in hindsight the issue should have been briefed. Both parties dropped the ball and the decision of the Tax Court stands.

Two holdings in Bobrow may nonetheless benefit taxpayers. The Tax Court rejected the IRS attempt to trace the withdrawals, and held that tracing was not relevant when the withdrawals consist only of cash or other property without distinguishable features. A taxpayer should be able to withdraw cash from an IRA for short term purposes and replenish the IRA with any other cash available within sixty days. The decision provides no guidance if the withdrawal consists of assets other than cash.

The Tax Court also allowed Mr. Bobrow to treat the two distributions from IRA #1 as a single withdrawal eligible for rollover treatment. The Tax Court left unresolved whether a taxpayer could aggregate distributions from separate IRAs, or from the same IRA but occurring on separate dates. A prudent taxpayer who requires more funds than exist in an IRA may consider consolidating IRAs by a custodian-to-custodian transfer first. The taxpayer could then withdraw the required cash from the consolidated IRA.

A taxpayer interested in using his or her IRA accounts for short term purposes should remember the following:

1. The tax-free withdrawal is available only once within a twelve month period, starting on the date of withdrawal;
2. The one rollover limitation applies to all of the taxpayer's IRAs, and cannot be applied to each IRA independently;
3. Only cash should be withdrawn; and
4. Funds should be consolidated by custodian transfer and withdrawn from a single IRA.

The IRS will follow the Bobrow decision for tax years beginning after December 31, 2014. The IRS will withdraw its prior proposed regulation that allowed one rollover for each IRA within the twelve month limitation.

We would be pleased to discuss this planning option with you in greater detail. Kind regards and best wishes for the New Year.

Kind regards.

Very truly yours,

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