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In this article, Blankenship analyzes the treatment of the earnings and investment portions of an IRA distribution that is partly rolled over to a qualified plan, a rollover with consequences that are often misunderstood.

A taxpayer generally cannot distribute after-tax investment from his IRA and avoid tax by leaving untaxed earnings in the IRA. Unfortunately, each IRA distribution must contain a proportionate amount of both taxable earnings and nontaxable investment.

Nevertheless, a taxpayer may be able to achieve a similar result by rolling over part of an IRA distribution tax free to a consenting qualified retirement plan.[1] The tax law limits such a tax-free rollover to the earnings portion of the distribution. Thus, the taxpayer may retain the nontaxable investment portion tax free. The taxpayer need only consummate the rollover to the qualified plan within 60 days of the distribution.[2] Alternatively, the IRA trustee may make a direct transfer of the earnings portion of the IRA distribution to the qualified plan and distribute the investment portion tax free to the taxpayer.

IRA Retention of Investment Is Problematic

In some circumstances, a taxpayer might want to argue that she should be able to roll over earnings from an IRA directly to a qualified plan without distributing any related investment (that is, by leaving the related investment in the IRA). Congress, after all, has shown that it approves of rollovers of only earnings (and not investment) from IRAs to qualified plans.[3] In fact, these rollovers of earnings draw on the aggregate earnings in all the taxpayer's IRAs.[4] What is the utility, then, of forcing unwanted distributions of related investment that undermine the general goal of allowing funds contributed to an IRA to accumulate tax free for retirement?

Unfortunately, however, these arguments are unlikely to prevail. Under the general statutory provisions governing the taxation of IRA distributions, a distribution to a taxpayer always includes some recovery of investment from the IRA (if the taxpayer has investment in the IRA).[5] The distribution includes investment whether or not the taxpayer is able to roll over all or part of the distribution to a consenting qualified plan. The code provides that the amount the taxpayer may roll over to the plan may not exceed "the *portion* of the amount *received*," which constitutes earnings.[6] For this purpose, earnings are determined in the usual way, regardless of the rollover. Thus, it is clear that the amount the taxpayer "receives" includes both the investment and earnings portions of the distribution.

The statutory provision limits the rollover to *an amount* equal to the earnings portion of the distribution but does not characterize the rollover

[1] A taxpayer may also roll over an IRA distribution tax free to a section 403(b) tax-sheltered annuity (TSA) or a section 457 eligible state or local government plan. Section 408(d)(3)(A)(ii). Thus, as used in this article, the term "qualified plan" includes TSAs and eligible state or local government plans.

[2] Section 408(d)(3)(A)(ii). Note that a taxpayer may make such a rollover only to a consenting plan. *Bohner v. Commissioner*, 143 T.C. 224 (2014).

[3] Section 408(d)(3)(A)(ii).

[4] Section 408(d)(3)(H)(ii)(II).

[5] Sections 72, 408(d)(1), (d)(2).

[6] Section 408(d)(3)(A)(ii) (emphasis added).

as earnings.[7] However, the code makes this clear in a separate provision. It treats the amount rolled over as earnings to the extent of the earnings in all the taxpayer's IRAs (without attempting to recharacterize the investment in the retained portion of the distribution).[8] Contrast that with qualified charitable distributions by IRAs, for which the code clearly specifies that "*the entire amount of the distribution* shall be treated as includible in gross income."[9] Consequently, after a rollover to a qualified plan, the taxpayer must always personally retain the investment component of the distribution, as well as any portion of the earnings component not rolled over.

Unlike the statutory provisions governing qualified plans, the provisions governing IRAs do not address trustee-to-trustee transfers. However, the IRS has treated trustee-to-trustee transfers between traditional IRAs as nontaxable transfers that are not distributions or rollovers — apparently under the unstated theory that they are mere substitutions of trustee that do not change the tax law applicable to the IRAs.[10] On the other hand, when an IRA trustee transfers funds directly to the trustee of an entity governed by different tax rules, the IRS and the tax law generally treat the transfer as in substance an actual distribution to the taxpayer and a transfer by the taxpayer to the other entity.[11]

Thus, a trustee-to-trustee transfer from an IRA to a qualified plan (governed by different tax rules) is the equivalent of an actual distribution from the IRA and a transfer by the taxpayer of the earnings portion of the distribution to the plan. As discussed above, the distribution itself must include some recovery of investment from the IRA (if the taxpayer has some investment in the IRA). Consequently, if the IRA does not actually distribute the investment to the taxpayer, the IRS may assert that a constructive distribution and re-contribution of the investment occurred that triggered the penalty tax on excess contributions.[12]

Of course, a taxpayer might argue that the constructive distribution and re-contribution of the investment back to the same IRA is itself a rollover. However, there does not appear to be any express statutory mechanism providing for a rollover of only the part of an IRA distribution consisting of investment.[13]

On the other hand, the IRS has provided that a taxpayer who receives a distribution from a *qualified plan* may roll over the earnings portion of the distribution to another qualified plan and roll over the investment portion to an IRA.[14] Arguably, then, a taxpayer who receives a distribution from an IRA should be able to accomplish the same thing.

Unfortunately, however, the analogy is considerably weakened by the different general rules applicable to rollovers from qualified plans and IRAs. In support of its flexibility regarding qualified plans, the IRS cited the general statutory provision mandating the rollover of plan earnings

[7] *Id.*

[8] Section 408(d)(3)(H)(ii).

[9] Section 408(d)(8)(D) (emphasis added).

[10] Rev. Rul. 78-406, 1978-2 C.B. 157. This revenue ruling does not explain the rationale for its holding. However, in an analogous situation, reg. section 1.403(b)-10(b) provides that a transfer from one TSA issuer directly to another TSA issuer is not a distribution but rather is a mere substitution of annuity issuers (*i.e.*, trustees), if specific tax law restrictions applicable to the old TSA under section 403(b) continue to apply to the newly acquired TSA. This TSA rule was substantially the same before promulgation of the regulation. *See* Rev. Rul. 90-24, 1990-1 C.B. 97 (now obsoleted by Rev. Rul. 2009-18, 2009-27 IRB 1).

The IRS has extended this non-distribution rationale to an exchange of an annuity distributed by a qualified plan for a new annuity when the qualified plan restrictions continued to apply to the newly acquired annuity after the exchange. GCM 39882 (Oct. 14, 1992). Also, the IRS has held that direct trustee-to-trustee transfers (not intended to be distributions) between qualified plans that are subject to the same restrictions under section 401 will not be treated as distributions. Rev. Rul. 68-160, 1968-1 C.B. 167; Rev. Rul. 71-541, 1971-2 C.B. 209.

[11] For example, the IRS has treated a trustee-to-trustee transfer from a SIMPLE IRA to a traditional IRA as if it were an actual distribution to the taxpayer and a transfer by the taxpayer to the traditional IRA. Notice 98-4, 1998-1 C.B. 269, Q&A I-4. The tax law treats a trustee-to-trustee transfer from a traditional IRA to a Roth IRA as if it were an actual distribution from the traditional IRA and a transfer by the owner to the Roth IRA. Section 408A(d)(3)(C), (d)(3); reg. section 1.408A-4, Q&A 1(b). *See also* Rev. Rul. 71-541, in which the IRS stated that some direct trustee-to-trustee transfers (not intended to be distributions) between plans qualified under section 401(a) will nevertheless be treated as distributions if the recipient plan is not made subject to the same restrictions imposed by the tax law on the transferring plan.

[12] Section 4973(a), (b).

[13] Section 408(d)(3).

[14] Notice 2014-54, 2014-41 IRB 670.

before investment.[15] By contrast, the general rule governing rollovers from IRAs requires proportionate allocations of earnings and investment. Although a more specific statutory provision overrides this general rule for an IRA rollover of earnings to a qualified plan, that provision does not mention the rollover of investment.[16]

Note, however, that if such a separate rollover of the investment portion should somehow pass muster with the IRS or the courts, the taxpayer might be able to roll over the distributed investment to a Roth IRA in a taxable qualified rollover contribution. Such a Roth conversion should not then be taxable since only nontaxable investment is rolled over. Of course, the taxpayer would have to satisfy all the usual requirements for the rollover, such as the requirement that the rollover be consummated within 60 days of the distribution, etc.

Examples Illustrating the Foregoing Discussion

Assume a taxpayer requests and receives a distribution of $40,000 from his IRA consisting of $10,000 of investment and $30,000 of earnings, computed by taking into account all the IRAs of the taxpayer. Assume the taxpayer rolls over the earnings portion of the distribution to a qualified plan. Then, neither the $30,000 of rolled-over earnings nor the $10,000 of retained investment is taxable to the taxpayer.[17]

Now consider a situation in which the taxpayer requests a distribution of $40,000 but asks that the IRA trustee transfer the $30,000 earnings portion of the distribution directly to the qualified plan. As part of the same transaction, the taxpayer requests that the IRA trustee distribute the $10,000 of related investment to him. Then, as in the indirect rollover, neither the $30,000 of rolled-over earnings nor the $10,000 of retained investment is taxable to the taxpayer.

Alternatively, the taxpayer may direct the IRA trustee to transfer directly to the plan less than all the earnings portion of the distribution. If so, the remaining portion of the distribution received by the taxpayer will consist of the portion of earnings not transferred to the plan (taxable) and the entire amount of the investment in the designated distribution (nontaxable).[18]

On the other hand, the taxpayer may simply request that the IRA trustee transfer $30,000 directly to the qualified plan, without further designating the total amount of the distribution. If so, the $30,000 direct transfer must consist only of earnings, because the taxpayer may not roll over investment from his IRAs to a qualified plan.[19] However, as discussed above, the total amount of the distribution necessarily includes a ratable portion of the taxpayer's investment in his IRAs.[20] Consequently, the IRA trustee should gross up the designated distribution to $40,000 to include the $10,000 of related investment. The trustee should then distribute the $10,000 of related investment to the taxpayer. Failure to distribute the investment could trigger penalties.

Some practitioners have suggested that a taxpayer could transfer the rolled-over earnings back into an IRA in the following year. That might work in some situations, but the taxpayer should be aware of the probable applicability of the substance-over-form doctrines.[21] If the taxpayer intended at the outset to make the transfer back to the IRA, the step transaction doctrine would likely apply and the rollovers would be collapsed into a mere IRA distribution equal to the investment in the IRA. That distribution would consist in part of taxable earnings.

Separate Treatment of the IRA Distribution

Generally, a taxpayer determines the tax treatment of distributions from his IRAs during a tax year by aggregating them (as if they were a single distribution from a single combined IRA).[22] However, the tax law provides that the taxpayer may not include a distribution in the aggregation (that is, must treat the distribution as separate) if

[15] *Id.*

[16] Section 408(d)(3).

[17] Section 408(d)(1), (d)(3)(A)(ii), (d)(3)(D).

[18] *Id.*

[19] Section 408(d)(3)(A)(ii).

[20] *See supra* text accompanying notes 10-11.

[21] For an analysis of the application of the substance-over-form doctrines to rollovers to IRAs and Roth IRAs, see Vorris J. Blankenship, "Rollovers to Roth IRAs Are Complicated by Substance-Over-Form Doctrines," *Taxes* 43 (Sept. 2015).

[22] Section 408(d)(2).

the taxpayer rolls over all or part of the earnings component of the distribution to a qualified plan.[23]

This separate treatment of a distribution does not change the computation of the investment and earnings components of the distribution based on the taxpayer's investment and earnings in all his IRAs.[24] The separate treatment is merely a recognition that unlike for other IRA distributions, some or all of the earnings portion of the distribution is neither taxable nor rolled over to another IRA. Further, unlike with other IRA distributions, the taxpayer does not allocate the computed investment component of the separate distribution proportionately between the amount rolled over and the amount retained.[25]

Rather, the taxpayer allocates the investment component of the separate distribution entirely and disproportionately to the retained portion of the distribution.[26] Thus, if the taxpayer were to aggregate the retained portion of the separate distribution with her other IRA distributions, the normal proportionate calculation would overstate the taxable earnings component.[27] Consequently, separate treatment of the separate distribution is not only a legal necessity, but a logical one.

For example, assume a taxpayer has three IRAs with a total year-end combined balance of $100,000 (after adjustments for distributions during the year). The adjusted balance consists of aggregate investment of $35,000 and earnings of $65,000 (that is, the taxpayer has an exclusion percentage of 35 percent). Assume the largest IRA had an adjusted balance of $50,000, consisting of aggregate investment of $30,000 and earnings of $20,000. Assume further that the taxpayer requested and received a distribution of $40,000 from the largest IRA during the tax year. The taxpayer then rolled more than $23,000 of the distribution to a qualified plan. The taxpayer also took $20,000 of other IRA distributions during the tax year that were not rolled over to other IRAs or plans. Then:

1. The $40,000 separate distribution includes investment of $14,000 — that is, the $40,000 distribution multiplied by the 35 percent combined exclusion ratio (computed by aggregating the taxpayer's three IRAs).[28] Of course, the remaining $26,000 of the distribution represents earnings.

2. The $23,000 rollover to the qualified plan consists entirely of amounts deemed drawn from the $65,000 aggregate earnings of all the taxpayer's IRAs, without allocation of any investment to the rollover — even though the distributing IRA itself has only $20,000 of earnings.[29]

3. The $17,000 portion of the separate distribution retained by the taxpayer consists of the $14,000 investment component of the distribution (nontaxable) and $3,000 of the earnings component of the distribution (taxable).[30]

4. The taxpayer may not aggregate the separate distribution with his other IRA distributions. Instead, the taxpayer computes the $7,000 investment portion of his other distributions by applying the 35 percent exclusion percentage separately to the $20,000 of other distributions.[31]

5. On the first day of the following tax year, the taxpayer's investment in his IRAs is $14,000 (the $35,000 initial investment for the preceding year less the $14,000 return of the investment in the separate distribution and less the $7,000 return of the investment in the other distributions).[32] ■

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[23] Section 408(d)(3)(H)(ii)(I).

[24] *See supra* text accompanying notes 7-8.

[25] Section 408(d)(3)(H)(ii)(II).

[26] *Id.*

[27] If the taxpayer were to apply the normal exclusion ratio to an aggregation of distributions that included the retained amount of the separate distribution, (1) the computed amount of investment recovery attributable to the retained amount would be less than (2) the actual disproportionate investment properly allocable to the retained amount.

[28] *See supra* text accompanying notes 7-8.

[29] Section 408(d)(3)(A)(ii), (d)(3)(D)(i), (d)(3)(H)(ii)(II).

[30] *Id.*

[31] Section 408(d)(3)(H)(ii)(I).

[32] Section 408(d)(3)(H)(ii)(III).