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FEATURE STORY

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Good news for taxpayers: the Internal Revenue Service extended these payments to retirement plans

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This year, the Internal Revenue Service extended to individual retirement accounts (IRAs) the concept of restorative payments -- payments made to restore losses due to a breach of fiduciary duty. In Private Letter Rulings 200705031 and 200719017, IRA owners settled claims against securities firms for losses sustained by their IRAs. The IRS allowed the IRA owners to put the settlement proceeds into their IRAs as restorative payments. The distinction between treating a payment as a contribution versus a restorative payment is important because a restorative payment can be made without regard to the usual limitations on contributions to an IRA.

This is good news for IRA owners who may have claims against financial advisors and their firms arising out of the sharp drop in the stock market between 2000 and 2003, particularly in the technology sector. These IRA owners, if successful in their claims, may be able to put the net award or the net settlement proceeds back into their IRAs as restorative payments.

IRA owners who receive money from the settlement of class action lawsuits involving securities in their IRAs also may be able to put these funds into their IRAs as restorative payments.

Prior Rulings

The IRS initially addressed restorative payments in Revenue Ruling 2002-45. In that ruling, an employer invested an unreasonable portion of a defined contribution plan's assets in a risky investment that became worthless. The Service ruled that if the employer restores the loss to the plan, either before or after a lawsuit is filed, the payment would be treated as a restorative payment and not as a contribution.

The Service explained that the determination of whether a payment to a qualified defined contribution plan is treated as a restorative payment or as a

contribution is based on all the relevant facts and circumstances. In its ruling, the IRS said that, in general, payments to a defined contribution plan are restorative payments only the payments are made to restore some or all of the plan's losses due to an action (or a failure to act) that creates a reasonable risk of liability for breach of fiduciary duty. In contrast, payments made to a plan to make up for losses due to market fluctuations and that are not attributable to a fiduciary breach are generally treated as contributions.

The Service also said that in no case will amounts paid in excess of the amount lost (including appropriate adjustments to reflect lost earnings) be considered restorative payments. Furthermore, payments that result in different treatment for similarly situated plan participants are not restorative payments.

During the past five years, the Service has applied Rev. Rul. 2002-45 to seven private letter rulings involving defined contribution plans.

In two rulings, taxpayers didn't fare too well. In PLR 200241046, the IRS ruled that the employer could deduct its restorative payments, but, because Rev. Rul. 2002-45 disposed of the issues involved, refused to rule that the restorative payments: (1) were not employer contributions to the plan; (2) would not adversely affect the plan's qualified status; (3) would not violate the nondiscrimination rules or be treated as annual additions; and (4) would not result in taxable income to the participants or beneficiaries.

In PLR 200317048, plan assets were invested in annuities with surrender charges. The Service held that this wasn't sufficient to demonstrate a reasonable risk of liability to the employer for the breach of fiduciary duty. So, the employer could not make a restorative payment to compensate the plan for the surrender charges of the annuities.

Despite the Service's comments in PLR 200241046, taxpayers fared better in subsequent rulings. In PLRs 200317050 (reimbursement for losses on second mortgage loans), 200334041 (reimbursement for losses on employer stock that participants were unable to sell due to blackout period in connection with a change of plan record keeper), 200640003 (reimbursement for diversion of plan assets by the trustee) and 200604039 (reimbursement for loss from a prohibited transaction), the Service ruled that payments by the employer to defined contribution plans were restorative payments.

IRAs

The first time the Service extended the concept of restorative payments to IRAs was in PLR 200705031. In that ruling, the IRA owner complained to an investment firm about losses resulting from the financial advisor's recommendations. After the IRA owner died in 2004, his wife, who was the IRA beneficiary, reached a settlement with the investment firm. Upon the advice of the IRA custodian, she deposited the settlement proceeds into her taxable account. The IRA custodian issued a Form 1099-MISC rather than a Form 1099R.

In 2005, she consulted with an attorney who advised her that she might be able to roll the settlement proceeds over into her IRA. The Service, applying the reasoning behind Rev. Rul. 2002-45, held that the payment -- as an arm's-length settlement of a good faith claim -- could be treated as a restorative payment, even though no lawsuit or arbitration proceeding had been brought.

In addition, the Service waived the 60-day deadline for a rollover, on the basis of the inappropriate advice from the IRA custodian; the issuance of a Form 1099-MISC rather than a Form 1099; the "dearth of authority" on when such payments are considered restorative payments; and the fact that she did not learn that the payment might be restorative until 2005.

In PLR 200719017, a husband and wife brought an arbitration proceeding against a securities firm for losses in their IRAs and their taxable accounts. The case was settled, with the settlement proceeds deposited into their attorney's trust account. The Service ruled that the net settlement proceeds should be allocated to the IRAs and the taxable accounts in proportion to the losses incurred in each account, and the portion allocated to each of the IRAs could be contributed to the respective IRAs as a restorative payment.

It thus appears that IRA owners can put restorative payments into their IRAs without fear that the IRS will characterize them as excess contributions. However, if the amount involved is sufficiently large, or there is some question as to whether it qualifies as a restorative payment, the IRA owner may wish to apply for his own PLR.

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