By Bruce D. Steiner

Restorative Payments

Qualified plans and IRAs that lost money in Ponzi schemes get some guidance from the IRS

In March 2009, Bernard L. Madoff pleaded guilty to federal charges involving a Ponzi scheme. In a Ponzi scheme, money contributed by new investors is used to make payments to existing investors. At some point, the perpetrator can't bring in enough new money to make the payments to existing investors, so the scheme eventually collapses.

Some of the investors who lost money in the Madoff scheme were qualified plans and individual retirement accounts. The court has appointed a trustee to administer the Madoff estate. The trustee has brought many lawsuits and has recently sought court authorization to make interim distributions to certain Madoff victims.

To the extent that qualified plans and IRAs are able to recover money lost in Ponzi schemes, the Internal Revenue Service has determined that the plans and IRAs should be able to put the recovered money back into the qualified plans and IRAs as restorative payments (that is, payments made to restore losses due to a breach of fiduciary duty) rather than as a contribution. This distinction is important because a restorative payment can be made without regard to the usual limitations on contributions to an IRA.

Similarly, the IRS has ruled that an employer should be able to make restorative payments to a qualified plan to compensate the plan for losses for which the employer has a reasonable risk of liability.

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 IRS ruled that if the employer restores the loss to the plan, either before or after a lawsuit is filed against the perpetrator of the fraud or the employer, the payment would be treated as a restorative payment and not as a contribution. The IRS 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 of the relevant facts and circumstances. In its ruling, the IRS said that in general, payments to a defined contribution plan are restorative payments only if 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 aren't attributable to a fiduciary breach are generally treated as contributions.

The IRS also said that it would never consider amounts paid in excess of the amount lost (including appropriate adjustments to reflect lost earnings) to be restorative payments. Furthermore, payments that result in different treatment for similarly situated plan participants aren't restorative payments.

Rev. Rul. 2002-45 also applies if a court-appointed trustee recovers money and gives it to the individual owner or employer, who in turn puts the payment into the retirement account. According to Rev. Rul. 2002-45, the payment is considered a restorative payment.

Concept Extended to IRAs

Rev. Rul. 2002-45 dealt with restorative payments to qualified plans. In the years since that revenue ruling was issued, the IRS has extended the concept of restorative payments to IRAs.

In a series of private letter rulings, IRA owners

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received awards or 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.

In PLR 200705031 (Feb. 2, 2007), the IRA owner (and following his death, his wife and daughter) exchanged letters with a financial institution regarding the suitability of the investments in the IRA. After a series of letters, the wife accepted a settlement, but she acted without counsel and without bringing a lawsuit or an arbitration proceeding. The financial institution issued a Form 1099, showing the settlement payment as miscellaneous income. The IRS ruled that the wife, as the beneficiary of the IRA, could roll the settlement proceeds over into her own IRA as a restorative payment. The IRS also waived the 60-day deadline for doing so.

> It appears that IRA owners can put restorative payments into their IRAs without fear the IRS will consider them to be excess contributions.

In PLR 200719017 (May 11, 2007), a husband and wife brought an arbitration proceeding against a financial institution regarding the suitability of their IRA and non-IRA investments in technology stocks. The case was settled, and the financial institution paid the settlement proceeds to the couple's attorneys, who put the money into their attorney trust account. The IRS ruled that the couple could prorate the proceeds, net of attorneys' fees and expenses, among their IRA and non-IRA losses and that each spouse could put the portion attributable to his or her IRA losses into his or her IRA as a restorative payment.

In PLR 200724040 (June 15, 2007), an IRA owner received an arbitration award for losses in connection with investments in tech stocks in her IRA. The IRS ruled that she could put the net amount of the award, after attorneys' fees and expenses, into her IRA as a restorative payment.

In PLR 200738025 (Sept. 21, 2007), a couple brought an arbitration proceeding with respect to losses in connection with investments in high-risk, aggressive mutual funds. The case was settled, and the proceeds were paid to the couple's attorney, who deducted his fees and expenses, sent the couple the portion of the net proceeds attributable to the non-IRA portion of the losses and sent the portion of the net proceeds attributable to the IRA losses directly to the couple's IRAs. The IRS ruled that the deposits to the IRAs were restorative payments.

In PLRs 200850054 (Dec. 12, 2008) and 200852054 (Dec. 26, 2008), the IRA owner received an arbitration award in connection with investment losses in his IRA. The award was for compensatory damages, punitive damages and a portion of the IRA owner's attorneys' fees and expenses. The award was paid to the IRA owner's attorneys, who deducted their fees and expenses and distributed the net proceeds to the IRA owner, who put the amount he received into his IRA. In connection with the ruling request, the IRA owner agreed to remove from his IRA the portion of the amount received that was in excess of the compensatory damages, less a pro rata portion of the attorneys' fees and expenses. The IRS ruled that the IRA owner could only restore the compensatory damages (less a pro rata portion of the attorneys' fees and expenses) but not the punitive damages. However, a reasonable argument could be made that the IRA owner should be permitted to put the award for punitive damages (net of attorneys' fees and expenses) into the IRA as well, since the award was with respect to the IRA. Indeed, had the IRA trustee brought the claim without an attorney and received the proceeds, that portion of the award would never have passed through the hands of the IRA owner or an attorney.

In PLR 200921039 (May 22, 2009), the IRS ruled that the payment to an IRA to restore unauthorized withdrawals by the financial representative was a restorative payment.

PLR 201007077 (Feb. 24, 2010) involved a qualified plan that may have invested with Madoff. The plan was a defined contribution plan consisting of a profit-sharing component and a 401(k) component. The employer controlled the investment of the profit-sharing component. Company C, a registered broker-dealer, managed a portion of the assets of the profit-sharing component for 14 years. The employer received regular account statements from Company C, which showed positive returns. Also, Company C honored distribution requests on a timely basis and kept other related operations for this account in order.

The president and founder of Company C was charged with engaging in a scheme that resulted in the widespread depletion of assets that had been placed under the management of Company C for investment. The next day, the Securities Investor Protection Corporation (SIPC) took control of Company C. Three days later, Company C filed for bankruptcy.

The employer filed a claim with the SIPC on behalf of the plan and each participant. The employer also notified and requested coverage from its employee benefits plan administration liability insurer, fiduciary liability insurer and crime loss insurer.

An IRA owner might want to apply for a ruling allowing her to put an award for punitive damages into her IRA.

The Department of Labor notified the employer that it was investigating the plan and served a subpoena on the employer requesting documents and records.

The employer proposed to make a restorative payment to the plan that would put the profit-sharing component of the plan in the financial position it would have been in, if it had invested the employer contributions with a company other than Company C. The employer made a partial payment of a percentage of the contributions that had been invested with Company C, adjusted by an earnings rate that an independent financial consulting firm determined the plan would have earned if it had invested in a typical blend of securities. Another consultant calculated the specific allocations to the participants' accounts. The employer proposed to allocate the interim payment to the participants' accounts upon receipt of a favorable ruling. The employer also proposed to make additional restorative payments to replace the contributions previously made, adjusted for the earnings the plan would have otherwise obtained.

The IRS ruled that the payments (1) would be restorative payments and not additional contributions, (2) wouldn't adversely affect the qualification of the plan, (3) wouldn't result in taxable income to the participants and beneficiaries, and (4) would be deductible by the employer as ordinary and necessary business expenses.

In applying the reasoning of Rev. Rul. 2002-45 to the facts of PLR 201007077, the IRS noted that the employer determined that there was a reasonable risk of liability for breach of fiduciary duty as a result of the losses sustained by the plan through the fraudulent action of Company C.

Is a PLR Needed?

It 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's some question as to whether it qualifies as a restorative payment (such as the punitive damage awards in PLRs 200850054 and 200852034), the IRA owner may wish to apply for her own PLR.

For example, even though IRA owners were unsuccessful on that issue in PLRs 200850054 and 200852034, an IRA owner who receives an award for punitive damages might want to apply for a ruling allowing her to put that portion of the award into her IRA, since the award relates to the IRA assets and investments. Similarly, notwithstanding the previous rulings to the contrary, an IRA owner might want to apply for a ruling allowing her to pay her attorneys' fees and expenses out of her non-IRA assets, since the attorneys' fees and expenses relate to the IRA assets and investments. The IRA owner might argue that the payment of attorneys' fees and expenses are analogous to the payment of IRA investment management and similar fees, which the IRS allowed the IRA owner to pay out of non-IRA assets in PLRs 200507021 (Nov. 23, 2004) and 201104061 (Nov. 4, 2010). Finally, an IRA owner might also request a ruling that payment of the attorneys' fees and expenses out of non-IRA assets is deductible under IRC Section 212 as an investment expense, which PLRs 200507021 and 201104061 hint at by referring to Rev. Rul. 84-146, 1984-2 C.B. 61.