

200714030



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

JAN 11 2007

Uniform Issue List: 408.00-00

LEGEND:

Taxpayer A =

Taxpayer B =

Attorney C =

Individual D =

Company M =

Company N =

Company O =

Amount 1 =

Amount 2 =

Amount 3 =

Amount 4 =

Amount 5 =

Amount 6 =

Amount 7 =

Amount 8 =

State T =

Plan X =

IRA Y =

IRA Z =

Settlement Agreement A =

Dear :

This is in response to a letter dated October 12, 2005, as supplemented by correspondence dated March 31, October 26, and November 17, 2006 and January 9, 2007, submitted on your behalf by your authorized representative, requesting a ruling regarding the status of contributions to your individual retirement account ("IRA"). You submitted the following facts and representations in connection with your request.

Taxpayer B, a resident of State T, died on \_\_\_\_\_ having attained age 65. Prior to his death, Taxpayer B participated in Plan X, a plan qualified under section 401(a) of the Internal Revenue Code (the "Code"). Taxpayer A, Taxpayer B's spouse, was the sole beneficiary of Taxpayer B's assets in Plan X. Following Taxpayer B's death, Taxpayer A's estate tax attorney recommended that she establish an IRA at Company M, with Individual D and/or his associate as her financial advisor, and transfer the assets in Plan X to the IRA. Accordingly, Taxpayer A established IRA Y at Company M, with Individual D and his associate listed as her financial advisors. On August 3, 2000, Amount 1 was distributed from Plan X to Taxpayer A and directly rolled over to IRA Y in a trustee-to-trustee transfer.

Over the next four and a half years, Individual D advised Taxpayer A regarding investing the assets originally rolled over to IRA Y. Beginning in 2002, at Individual D's recommendation that she diversify her investments, Taxpayer A liquidated IRA Y and invested and reinvested the assets in various IRA annuities. In 2003, Individual D suggested that Taxpayer A further diversify her portfolio by investing her assets in real estate through tax qualified rollovers from her IRA annuities. In response to Individual D's advice, Taxpayer A liquidated the remaining assets in her IRA annuities and wrote checks to Individual D, Individual D's company ("Company N"), and another entity. In January of 2005, Taxpayer A's daughter, a certified public accountant, audited her mother's accounts because she became concerned that her mother's IRA assets were becoming depleted due to improper handling. She found that Taxpayer A's IRA assets had not been invested in real estate and that some of Taxpayer A's checks had been deposited into the personal checking account of Individual D's sister. In January of 2005, it was also discovered that Individual D had been fired from Company M in 2003, although he had continued to represent himself as an employee of Company M and Company M had failed to notify Taxpayer A of his removal. During the four and a half year period under Individual D's financial management, the amount of Taxpayer A's original investment, net of withdrawals in Amount 2 for her living expenses, decreased by 99 percent (from Amount 3 to Amount 4, resulting in a loss of Amount 5).

Taxpayer A represents that, to try to dissuade Taxpayer A from taking legal action against him, Individual D made payments totaling Amount 6, almost all of which was

paid to Taxpayer A in calendar year 2005. On March 23, 2005, on the advice of Taxpayer A's attorney, Attorney C, Taxpayer A deposited a portion of this amount, Amount 7, into IRA Z with Company O. On April 29, 2005, Attorney C filed a lawsuit against Individual D's Company N seeking a full accounting and detailed explanation of the disposition of Taxpayer A's IRA assets. On April 8, 2005, Attorney C filed Taxpayer A's Statement of Claim for arbitration with The National Association of Securities Dealers, Inc. against Company M requesting damages for losses suffered by Taxpayer A. The claim was based on several provisions of State T's securities law, including reckless conduct, negligent supervision, breach of fiduciary duty and breach of contract. In the claim, Taxpayer A alleged that Individual D stole and misappropriated the assets originally invested in IRA Y, net of her withdrawals, resulting in remaining assets of Amount 4 (in addition to the amounts reimbursed by Individual D as of the date of the filing). On November 3, 2005, Taxpayer A entered into a final settlement, Settlement Agreement A, with Individual D, Company M, Company N, and other potential defendants associated with Individual D. Under the terms of Settlement Agreement A, Company M paid Taxpayer A an additional amount, Amount 8, to settle all of her claims against the parties to the agreement. Amount 8 was paid to Taxpayer A on November 25, 2005, and transferred directly from Company M to IRA Z. On March 7, 2006, State T brought a criminal action against Individual D for forgery, fraud, theft, and unlawful actions by a fiduciary, in connection with Individual D's handling of Taxpayer A's IRA assets. Individual D pleaded guilty to elements of the crimes of attempted unlawful dealing of property and attempted forgery, including unlawful dealing in property entrusted to him as a fiduciary.

Based upon the foregoing, you request a ruling that Amount 7 and Amount 8 be considered restorative payments to IRA Z and not subject to the rules for contributions or rollovers to IRAs.

With respect to the requested letter ruling, section 408(a) of the Code provides that, for purposes of this section, the term "individual retirement account" means a trust created or organized in the United States for the exclusive benefit of an individual or his beneficiaries, but only if the written governing instrument creating the trust meets certain requirements. Among these requirements is the one found in paragraph (1) of section 408(a) which states that, except in the case of a rollover contribution described in subsection (d)(3), in section 402(c), 403(a)(4), 403(b)(8), or 457 (e)(16), no contribution will be accepted unless it is in cash, and contributions will not be accepted for the taxable year in excess of the amount in effect for such taxable year under section 219(b)(1)(A) on behalf of any individual.

Revenue Ruling 2002-45, 2002-2 C.B. 116 ("Rev. Rul. 2002-45"), applies a facts and circumstances test to determine whether a payment to a plan qualified under Code section 401(a) is a restorative payment or a contribution to the plan. Under Rev. Rul. 2002-45, payments made merely to replenish a participant's account in a defined contribution plan after investment losses are to be treated as contributions. On the other hand, payments that are made to restore some or all of the account's losses due to an action (or failure to act) that creates a reasonable risk of liability are restorative

payments. In addition, in order to be a restorative payment, the payment does not need to be the result of legal action; it only needs to be made as a result of a reasonable determination that there is a reasonable risk of liability. Rev. Rul. 2002-45 also provides that the amount of a restorative payment cannot exceed the initial amount of the investment.

Applying the reasoning of Rev. Rul. 2002-45 to IRAs, payments to an IRA are restorative payments only if the payments are made in order to restore some or all of the IRA losses resulting from breach of fiduciary duty, fraud or federal or state securities violations (such as payments made pursuant to a court-approved settlement or independent third-party arbitration or mediation award). In contrast, payments made to an IRA to make up for losses due to market fluctuations or poor investment returns are generally treated as contributions and not as restorative payments.

In this case, there is ample evidence to indicate that Amount 6 and Amount 8 were paid to replace Taxpayer A's IRA losses due to actions that created a reasonable risk of liability for Individual D and Company M. Taxpayer A filed two legal claims alleging illegal conduct, one against Individual D's Company N, and one against Company M, in connection with these losses. At the end of 2004 and during 2005, when Taxpayer A became concerned about the handling of her IRA assets, Individual D made payments to Taxpayer A totaling Amount 6. Individual D was also a party to Settlement Agreement A, under which an additional Amount 8 was paid to Taxpayer A by Company M pursuant to a settlement agreement on a date following Individual D's last payment included in Amount 6. Although Company M denied liability in the settlement agreement, the parties agreed that upon payment of Amount 8, Taxpayer A would withdraw her claim filed with The National Association of Securities Dealers and release the parties from all liability associated with the alleged actions or omissions of Company M, Individual D, Individual D's sister, and Company N. Thus, it is clear that Amount 6 and Amount 8 were paid to restore losses due to actions that created a risk of liability for Company M and Individual D. The portion of Amount 6 that was paid to IRA Z, *i.e.*, Amount 7, and Amount 8 do not exceed Amount 5, the amount of Taxpayer A's original investment in IRA Y net of withdrawals for her living expenses and Amount 4 (the assets remaining in her IRA). Thus, based on the facts and circumstances in this case, we conclude that Amounts 7 and 8 are considered restorative payments to IRA Z, and not contributions subject to the limitations on contributions under Code section 408(a)(1) or 408(d)(3).

This ruling letter is based on the assumption that Taxpayer A's IRA Y was an IRA described in Code section 408(a) as represented at all times relevant thereto. It also assumes that IRA Z meets the requirements of section 408(a).

No opinion is expressed as to the tax treatment of the transaction described herein under the provisions of any other section of either the Code or regulations that may be applicable thereto.

This letter is directed only to the taxpayer who requested it. Code section 6110(k)(3)

provides that it may not be used or cited as precedent.

A copy of this letter has been sent to your authorized representatives in accordance with a power of attorney on file in this office.

If you wish to inquire about this ruling, please contact

Sincerely yours,

*Carlton A. Watkins*

Carlton A. Watkins, Manager  
Employee Plans Technical Group 1

Enclosures:

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