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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

200850054

SEP 18 2008

Uniform Issue List: 408.03-00

Legend:

Taxpayer A =

Company S =

Respondents G =

IRA X =

Association M =

Case Number D =

Award N =

State Z =

Investment Advisor G =

Attorney H =

Date 1 =

Date 2 =

Date 3 =

Amount A =

Amount A-1 =

Amount B =

Amount C =

Amount D =

Amount E =

Amount F =

Dear

This is in response to your letters dated July 10, 2007, January 2, 2008, April 8, 2008, September 4, 2008, and September 11, 2008, submitted by your authorized representative, concerning the status of a contribution to your individual retirement account (IRA).

The following facts and representations have been submitted under penalties of perjury in support of your request.

Taxpayer A established an individual retirement arrangement, IRA X, with Company S, a member of Association M, on Date 1, 1998. Individual A relied upon investment advice built upon a long term relationship with Investment Advisor G. Investment Advisor G was associated with Company S and was named as one of the respondents in the Date 2, 2004 filing by Taxpayer A of Case Number D before Association M for damages (the Arbitration).

The Arbitration asserted causes of action including: breach of fiduciary duty; negligence; breach of contract; common law fraud; misrepresentation; violation of the State Z Securities Laws; violation of the State Z Deceptive Trade Practices Act; violation of the State Z I Code; and control person liability for Company G and Company S. Each of the causes of action related to the recommendation and purchase of certain index-based mutual funds with high fees and trading costs. Specifically, the Statement of Claim in the Arbitration alleged that Respondents G, through the actions of Investment Advisor G, arbitrarily changed the IRA X account investment objective from moderate to aggressive while acting with full investment discretion. The Statement

of Claim alleged that under the asset management of Respondents G, the IRA X retirement asset mix of long held retirement mutual funds evolved over a five year period to an asset mix made up of index based leveraged mutual funds of the type associated with high fees and trading costs which the Statement of Claim alleged were recognized in the investment world as some of the most volatile and speculative securities created. In addition, the Statement of Claim alleged that Respondents, after incurring large losses of approximately 50%, began day trading of index based mutual funds in an attempt to reverse the portfolio losses.

On Date 3, 2006, an Association M arbitration panel issued Award N which awarded compensatory damages of Amount A, punitive damages of Amount B, costs of litigation of Amount C and attorney's fees of Amount D to Taxpayer A. Actual attorney fees and costs exceeded Amounts D and C by Amount E.

The entire amount awarded under Award N was received by Taxpayer A's attorney, Attorney H. Attorney H's firm then distributed Amount F representing the amounts awarded under Award N net of attorneys fees and costs including Amount E to Taxpayer A.

Taxpayer A received Amount F from Attorney H which he deposited into IRA X within 60 days of receipt.

Taxpayer A has stated that he will remove from IRA X all amounts in excess of Amount A-1, which represents the original contribution of Amount F attributable to the award of compensatory damages less the pro-rata portion of the difference between the actual and awarded attorneys fees and costs attributable thereto plus income thereon.

Based upon the foregoing, you request the following ruling:

> That the amount paid by Respondents G and remitted to Taxpayer A representing net compensatory damages in Case Number D before Association M, Amount A-1. which was paid over and contributed by Taxpayer A to IRA X was contributed as a replacement payment to IRA X. As such, said Amount A-1 did not constitute an ordinary contribution to IRA X subject to the limitations of Code sections 219 and 408.

With respect to the requested ruling, Code sections 219 and 408 govern the timing and amount of contributions to Individual Retirement Arrangements (see e.g., Code section 219(b)(1), 219(b)(5), 219(f)(3) and 408(d)(4)).

Code section 408(d)(1) provides, generally, that, except as otherwise provided in this

subsection, any amount paid or distributed out of an individual retirement plan shall be included in gross income of the payee or distributee in the manner provided under section 72.

Code section 408(d)(4)(A) provides, in summary, that paragraph (1) does not apply to any distribution of any amount contributed to an IRA during a taxable year if (A) said distribution is made on or before the due date of the return for the taxable year (including extensions), (B) no deduction is taken for said amount under Code section 219, and (C) interest attributable to said amount accompanies the distribution.

The issue in this case is whether the Internal Revenue Service should treat Amount A-1 received by Taxpayer A, and contributed to his IRA X, as an amount that replaces losses suffered by Taxpayer A's IRA X and, as a result, not treat the contribution of Amount A-1 to IRA X as an ordinary contribution subject to the limitations of Code sections 219 and 408.

It has been represented that Taxpayer A initiated an arbitration action against Respondents G relating to significant losses in value of various assets of IRA X set up and maintained in the name of Taxpayer A. It has been represented, and documentation submitted in conjunction with this ruling request supports the representation, that the arbitration action was settled "in good faith". Pursuant to the settlement, Taxpayer A was awarded Award N which consisted of Amount A (compensatory damages), Amount B (punitive damages), Amount C (costs of litigation), and Amount D (attorney's fees). Actual attorney fees and costs exceeded Amounts D and C

A determination of whether settlement proceeds should be treated as replacement payment, rather than an ordinary contribution, must be based on all the relevant facts and circumstances surrounding the payment of the settlement proceeds (see Revenue Ruling 2002-45, 2002-2 C.B.116, which applies a facts and circumstances test to determine whether a payment to a qualified plan under Code section 401(a) is a restorative payment to a plan as opposed to a plan contribution). We believe that it is appropriate to apply the reasoning of Rev. Rul. 2002-45 to payments made to IRAs.

As a general rule, payment 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 the instant case, Taxpayer A instituted an Association M Arbitration proceeding, Case Number D, against Respondents G. The Statement of Claim in Case Number D contained factual allegations to the effect that Respondents G made multiple unauthorized transactions in Taxpayer A's IRA, such as changing the investments from long standing conservative mutual funds to trading on a nearly daily basis in volatile speculative leveraged index-based funds. It was also alleged that actions of Respondents G were the proximate cause of the loss suffered by IRA X. As noted above, the claim in Case Number D was settled in "good faith".

Accordingly, from the facts presented in this case, the payment from Respondents G to Taxpayer A was the result of an arm's length settlement of a good faith claim of liability. As a result, certain portions of Award N may be eligible to be contributed to IRA X as a replacement payment.

Award N consisted of compensatory damages, punitive damages, recovery of costs, and attorney fees. Of said payment types, only compensatory damages are eligible to be treated as replacement payments. However, a pro-rata portion of the compensatory damages awarded in this case was retained by Taxpayer A's counsel as a portion of their fees and as a portion of Taxpayer A's costs in bringing Case Number D. Such pro-rata portion is part of Taxpayer A's costs of recovery, and, as such, may not be contributed to IRA X as a replacement payment.

As a result of the above, the portion of Amount A that may be treated as a replacement payment to IRA X is the difference between Amount A and the pro-rata portion of Taxpayer A's costs and fees. Such amount is Amount A-1. Thus, Amount A-1 represents Taxpayer A's permissible replacement payment. Therefore, Taxpayer A's contribution of Amount A-1 to IRA X constituted a replacement payment not subject to the limits on contributions to an IRA found in Code sections 219 and 408.

Additionally, any amounts awarded to Taxpayer A pursuant to Award N and contributed by Taxpayer A to his IRA X, to the extent said contributed amounts exceeded Amount A-1, constituted amounts subject to the limitations of Code sections 219 and 408 and, potentially, excess contributions to said IRA X. If excess contributions, any corrective distribution thereof must include income attributable thereto.

Finally, with respect to your ruling request, we conclude as follows:

> That the amount paid by Respondents G and remitted to Taxpayer A representing net compensatory damages in Case Number D before Association M, Amount A-1, which was contributed by Taxpayer A to IRA X was contributed

as a replacement payment to IRA X. As such, said Amount A-1 did not constitute an ordinary contribution to IRA X subject to the limitations of Code sections 219 and 408.

Please note that income attributable to Amount A-1 may be retained in IRA X. Said income does not constitute a contribution thereto.

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

This ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

A copy of this letter is being sent to your authorized representative in accordance with a Power of Attorney (Form 2848) on file in this office.

If you wish to inquire about this ruling, please contact
Please address all correspondence to SE:T:EP:RA:T3.

Sincerely yours,

Frances V. Sloan

Frances V. Sloan, Manager
Employee Plans Technical Group 3

Enclosures:
Deleted copy of letter ruling
Notice of Intention to Disclose