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

OFFICE OF
CHIEF COUNSEL

CC:NTA
SPR-100687-99

August 19, 1999

MEMORANDUM FOR W. VAL OVESON
NATIONAL TAXPAYER ADVOCATE
Attn: Senate Finance Committee Project Team

FROM: Arlene A. Blume
Office of Counsel to the National Taxpayer Advocate

SUBJECT: Correspondence concerning [redacted]

This memorandum responds to your request for legal assistance in responding to a Senate Finance Committee inquiry concerning two taxpayers who failed to meet the 60 day rollover requirement for their IRA after investing their retirement savings into a Ponzi scheme that had been marketed as a qualifying IRA. You have asked whether, as a result of failing to roll over the funds, the [redacted] must include the distribution in taxable income and, if so, whether we can find any judicial or administrative remedies to help them. Despite extensive efforts to find an equitable remedy for [redacted] under the Code, the Associate Chief Counsel (EBEO) has been unable to find a legal basis under which the [redacted] could exclude their embezzled retirement distribution from income in [redacted] This memorandum incorporates the assistance provided by that office.

NOTE: [redacted] the [redacted] attorney, has asked that you contact him before providing a final response.

FACTS

[redacted] received a $[redacted] distribution from the [redacted] qualified pension plan on [redacted], when they were both under the age of [redacted] [redacted] their financial counselor, advised them to deposit the distribution into a [redacted] within sixty days of receiving the distribution to avoid immediate taxation of the distribution. The [redacted] deposited the distribution into their personal bank account and, on the same day, wrote two checks totaling $[redacted] to [redacted], a firm that [redacted] had established. The [redacted] believed that [redacted] would

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Date	8/19/99	8-19-99					

set up the [redacted] IRA account for them and deposit the funds within 60 days. [redacted] did not set up the IRA, but instead embezzled the [redacted] funds. The [redacted] relied upon [redacted] representations and were not aware that he had stolen their retirement funds until [redacted] when [redacted] was arrested.

The [redacted] reported the income from the distribution and the additional tax on their Form 1040 for [redacted]. However, they were unable to fully pay the tax. The Collection Division attempted to collect the tax, but eventually labeled the account as "currently not collectible." On [redacted], the [redacted] filed a 1040X, claiming a theft loss deduction for [redacted]. The Service denied the claim. Instead, the Service determined in early [redacted] that [redacted] incurred a theft loss in [redacted] adjusted the tax for that year, and allowed the carryback of the excess operating loss to reduce the taxes reported by the [redacted] in [redacted], [redacted] and [redacted]. The tax overpayments generated from the [redacted] adjustment were credited to the outstanding [redacted] liability, but (because of the tax rate structure) did not significantly reduce the outstanding liability for [redacted]

On [redacted], the [redacted] filed a second 1040X for [redacted], excluding the entire pension plan distribution from income on the grounds that they had, in fact, completed the IRA contribution when they issued the checks to [redacted] in its alleged capacity as an agent of [redacted]

On [redacted] the Service reversed the uncollectible status of the [redacted] debt. On [redacted] the [redacted] entered into an installment agreement and began making monthly payments in the amount of $[redacted] on the [redacted] liability. The [redacted] have continued to pay monthly since that date. The tax owed has decreased from an estimated $[redacted] in [redacted] to $[redacted] as of [redacted], but (with interest and the failure to pay penalty) the balance due for [redacted] now totals $[redacted]

ISSUES:

1. Whether the taxpayers, whose intended rollover of a qualified pension plan distribution into an IRA was thwarted by their financial counselor's embezzlement of the funds, must nevertheless include the pension plan distribution in income.

2. Whether any administrative or judicial remedies are available for the taxpayers.

CONCLUSIONS:

1. There is no legal basis to grant relief to the [redacted] under the pension provisions.

2. We recommend that the [redacted] submit an offer in compromise under the new tax administration criteria for an offer in compromise.

LEGAL ANALYSIS:

1) The tax liability on the pension fund distribution and theft loss

Counsel has been working for several years to find statutory authority for relieving the [redacted] of the tax liability incurred on the early distribution of the pension funds. Regional Counsel for the Western Region contacted the Associate Chief Counsel (EBEO) on May 14, 1996 concerning a congressional inquiry regarding the [redacted] when it was unable to provide a taxpayer-favorable to the Laguna Niguel District Problem Resolution Office. The memo explains that, in the view of the Western Region, the [redacted] could not be relieved of their tax liability based upon existing legal authority. After analyzing the issues, the Associate Chief Counsel (EBEO) concurred with this conclusion. The [redacted] attorney provided additional information concerning [redacted] alleged status as an agent of [redacted] on September 20, 1996. The Laguna Niguel District Counsel Office concluded that the additional information did not change the conclusion, and the Associate Chief Counsel (EBEO) again concurred. On December 22, 1997, Western Regional Counsel informed the [redacted] attorney that the Service could not grant relief under the law.

Under I.R.C. § 402(a), distributions from qualified pension funds are generally taxable in the year in which the distribution occurs. A taxpayer can avoid immediate taxation by transferring the distributed property to an eligible retirement plan within sixty days of receiving it. I.R.C. §§ 402(c)(1)(B) and 402(c)(3). Eligible retirement plans include an individual retirement account (IRA) as described in I.R.C. § 408(a). I.R.C. §§ 402(c)(8)(B)(i). Because the 60 day rollover period is provided by statute, the Service lacks authority to extend it under Treas. Reg. § 1.9100-1.

Taxpayers become liable for income tax on the distribution of funds from a retirement account when they fail to roll over the funds into another eligible retirement account, even though they intended to do so or believe they had properly done so, Wood v. Commissioner, 93 T.C. 114, 119 (1989); Grant v. Commissioner, T.C.Memo. 1995-29; Orgera v. Commissioner, T.C. Memo. 1995-575. Neither the Code nor the regulations provide relief from this taxation if, for whatever reason, the money distributed from a qualified plan in not deposited within the sixty days. Wood, 93 T.C. at 199.

In Wood, the Tax Court found that a rollover had nonetheless occurred, despite an error in transferring funds at the brokerage, because both the taxpayer and the brokerage firm, as trustee, had taken the necessary steps to open the IRA account and to transfer funds into that account. Only a bookkeeping error by the properly appointed trustee kept all of the funds from being transferred from a ready asset account at the brokerage into the IRA account.

The importance of delivering the funds to a qualifying trustee was reiterated most recently in Schoof v. Commissioner, 110 T.C. 1 (1998). In Schoof, the Tax Court held that, where a taxpayer who gives a distribution intended as a rollover to a trustee who is not qualified under section 408(a)(2), the taxpayer is denied the rollover treatment and must include the distribution in income. In reaching this decision, the court specifically held that Wood was distinguishable because it merely involved "procedural defects [by the trustee] in the execution of the rollover" rather than "the failure of a fundamental element of the statutory requirements...the qualification of the IRA trustee." Schoof at 11.

Unlike the taxpayers in Wood and Schoof, the [redacted] did not undertake the steps necessary to formally establish their IRA accounts with [redacted] before [redacted] absconded with their money. [redacted] established IRA accounts with [redacted] for other investors and for other funds the [redacted] invested through him, but he failed to take that critical step with the funds in question. Although he had an ongoing business relationship with [redacted] [redacted] did not present himself as an agent for [redacted], and the [redacted] did not, at any time, understand him to be an agent for [redacted]. [redacted] took their money before it was invested in an IRA with [redacted]. Because of his larceny, the funds distributed from the [redacted] qualified pension plans were never rolled over into an qualified IRA or delivered to a qualified IRA trustee. Under current law, the distribution is fully taxable in [redacted]

While the distribution and, apparently, the theft took place in [redacted], the theft loss from [redacted] larceny was not sustained until [redacted]. I.R.C. § 165(a) allows a deduction for any loss, including theft losses, sustained during the taxable year and not compensated by insurance or otherwise. Section 165 (e) specifically provides that "any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers such loss." The [redacted] did not discover that [redacted] had stolen their retirement funds until after [redacted] was arrested in [redacted]

The Service attempted to apply the law in the [redacted] best interests by allowing the [redacted] a full deduction for the theft loss in [redacted]. The [redacted], however, had significantly less income in [redacted] than they had reported in [redacted], when they included in income the $[redacted] pension distribution. Thus, the [redacted] were unable to fully deduct the pension loss in [redacted] and were left to carry the excessive loss back to [redacted], [redacted], and [redacted] under the mechanical application of the net operating loss carryback rules of I.R.C. § 172. The overpayments for each year were then credited to the [redacted] liability. Because the [redacted] smaller income for

[redacted] was taxed at a lower net rate than their [redacted] income, they were still left with a substantial unpaid tax liability for [redacted] [1]

2) Administrative and judicial remedies

a. Refund suit and other judicial remedies

In their original return for [redacted], the [redacted] included the amount of the embezzled distribution is inculpable in income. They were unable, and continue to be unable, to pay the tax liability associated with the return. The taxpayers have since filed two amended returns claiming refunds, the first of which was filed in [redacted] and denied by the Service in early [redacted]. The taxpayers filed a second amended return on [redacted]. We cannot determine, based upon the transcript of account, whether the Service has processed or formally denied a claim for abatement or refund of tax in that return.

For the legal reasons set forth above, the Service is unable to authorize a refund based upon the [redacted] claim. Based upon the Tax Court precedents, we doubt that a court would reverse the Service's determination.

However, if the [redacted] disagreed with the Service's application of the law, the next procedural step in contesting the liability would be to file a refund suit under I.R.C. § 7422. Here, it appears that the [redacted] who are making $[redacted] per month payments under an installment agreement, are precluded from filing a refund suit because they are unable to satisfy their tax liability in full. Although the [redacted] might be able to timely file a refund suit based upon their second amended return, they must also pay the full amount of the disputed taxes before a court can assume jurisdiction over the claim. See Flora v. United States, 362 U.S. 145, 150 (1960), aff'g on reh'g 357 U.S. 63 (1958). Their attorney indicates that they cannot make the payments.

The [redacted] will not have an opportunity to contest the Service's determination in a judicial proceeding without first paying the tax. They cannot use the pre-assessment dispute process to contest a deficiency proposed by the Service before the United States Tax Court because, by including the distribution in income on their initially filed return for [redacted] they consented to the initial assessment of the tax. In addition, their amended returns do not provide a vehicle in this case for the [redacted] to proceed to Tax Court because the amended returns do not give rise to a deficiency determined by the Service. In Fayeghi v. Commissioner, T.C. Memo. 1998-297, the Tax Court held that an amended return constitutes a claim for refund that the Commissioner may review and adjust either by way of an immediate rejection of the refund claim, or by tentative allowance, subsequent audit, and if necessary, issuance of a notice of deficiency. The Tax Court went on to hold that

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[1] We have not attempted to recompute the net operating loss carrybacks or their effect on the [redacted] tax liabilities for [redacted]

the Service's rejection of a claim for refund or abatement in an amended return does not convert a disallowed claim into a deficiency within the meaning of section 6211(a). Similarly, the Fourth and Seventh Circuits have held that, for the purpose of figuring a deficiency, the amount shown as the tax by the taxpayer upon his return is the amount shown on the original return, not the amended return. Koch v. Alexander, 561 F.2d 1115 (4th Cir. 1977); Curry v. United States, 774 F.2d 852 (1985).

b. Offer in compromise

We recommend that the [redacted] consider filing an offer in compromise under the new "equity" guidelines. In July, the Internal Revenue Service published temporary and proposed regulations, effective on July 21, 1999, that provide additional guidance regarding the compromise of internal revenue taxes. Treas. Reg. § 301.7122. 64 Fed Reg. 39020 (July 21, 1999). In section 7122, Congress has authorized the Service to compromise any civil case pursuant to guidelines prescribed by the Secretary. Traditionally, the Service has determined that it is authorized to compromise a case solely upon doubt as to a liability or doubt as to collectibility. In the new temporary and proposed regulations, the Service added a third criteria for offers when "collection of the entire tax liability would create economic hardship or if exceptional circumstances exist in which collection of the entire tax liability would be detrimental to voluntary compliance." Temp Treas. Reg. 301.7122-1T, T.D. 8829, provides these standards:

> (b) Grounds for compromise. (1) In general. The Secretary may compromise a liability on any of the following three grounds.
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> (2) Doubt as to liability. Doubt as to liability exists where there is a genuine dispute as to the existence or amount of the correct tax liability under the law. Doubt as to liability does not exist where the liability has been established by a final court decision or judgment concerning the existence or amount of the liability. See section 301.7122(e)(4) for special rules applicable to rejection of offers in cases where the IRS is unable to locate the taxpayer's return or return information to verify the liability.
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> (3) Doubt as to collectibility. (i) In general. Doubt as to collectibility exists in any case where the taxpayer's assets and income are less than the full amount of the assessed liability.
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> (4) Promote effective tax administration. If there are no grounds for compromise under paragraphs (b)(2) and (3) of this temporary regulation, a compromise may be entered into to promote effective tax administration when ---

(i) Collection of the full liability will create economic hardship within the meaning of section 301.6343-1; or

(ii) Regardless of the taxpayer's financial circumstances, exceptional circumstances exist such that collection of the full liability will be detrimental to voluntary compliance by taxpayers; and

(iii) Compromise of the liability will not undermine compliance by taxpayers with the tax laws.

(iv) Special rules for evaluating offers to promote effective tax administration.

(A) The determination to accept or reject an offer to compromise made on the ground that acceptance would promote effective tax administration within the meaning of this section will be based upon consideration of all the facts and circumstances, including the taxpayer's record of overall compliance with the tax laws.

(B) Factors supporting (but not conclusive of) a determination of economic hardship under paragraph (b)(4)(i) include --

(1) Taxpayer is incapable of earning a living because of a long term illness, medical condition, or disability and it is reasonably foreseeable that taxpayer's financial resources will be exhausted providing for care and support during the course of the condition;

(2) Although taxpayer has certain assets, liquidation of those assets to pay outstanding tax liabilities would render the taxpayer unable to meet basic living expenses; and

(3) Although taxpayer has certain assets, the taxpayer is unable to borrow against the equity in those assets and disposition by seizure or sale of the assets would have sufficient adverse consequences such that enforced collection is unlikely.

(C) Factors supporting (but not conclusive of) a determination that compromise would not undermine compliance by taxpayers with the tax laws include --

(1) Taxpayer does not have a history of noncompliance with the filing and payment requirements of the Internal Revenue Code;

(2) Taxpayer has not taken deliberate actions to avoid the payment of taxes; and

(3) Taxpayer has not encouraged others to refuse to comply with the tax laws.

As discussed above, there does not appear to be any significant doubt concerning the [redacted] liability for the tax, penalty and interest for the [redacted] tax year. The Service has previously solicited an offer in compromise from the [redacted] on the grounds of collectibility. The [redacted] declined to submit the offer because they want to preserve some of their remaining assets and fear losing them to pay the Federal and California state tax liabilities on the pension distribution.

We believe the [redacted] should file an offer under Paragraph (b)(4) above. The transcripts show that [redacted], apart from this incident, have a history of complying with the tax laws and that they have tried to comply with those laws in this case. They continue to make regular payments while searching for a remedy. If the [redacted] had succeeded in establishing their IRA accounts, they would have been successful in deferring the tax on their pension distributions until they removed such funds from the IRAs. If they were allowed to claim a theft loss in the same year in which they included the distribution of the funds in income, the loss deduction would have substantially netted out the distribution income. Thus, the [redacted], based upon actions outside their control, have incurred a substantial tax liability that is, for the most part, attributable to when they discovered [redacted] theft of their pension funds.

The Service cannot promise that its acceptance of an offer in compromise will have any effect on the [redacted] California tax liability, However, the [redacted] might be able to convince the California tax authorities to take similar action if the Service were to actually abate a portion of the [redacted] Federal tax liability pursuant to an offer in compromise.

If you have further questions, call Arlene Blume at 202-927-0320.