IRA Distributions and "Restorative Payments"

Friday, November 17, 2023

Take-Away: Sadly, many elders are vulnerable to fraud when it comes to their IRAs. Few remedies exist for the victims who have lost their IRAs yet have had to pay the income taxes on the fraudulently induced distributions.

Background: A few weeks back I wrote about *Gomas v. U.S. (July 17, 2023)* in which a federal District Court held that an elderly couple who had been defrauded by their daughter to the tune of $1,133,000+ in distributions from their IRA were required to pay the income taxes on the IRA distributions of $412,000 and were not entitled to an income tax refund, even though they never received the distributed amounts. This result was no different than another federal court case that I reported on about 4 years ago, in *Nice v. U.S. (2019),* where a son induced his mother to take distributions of over $500,000 from her IRA which the son then spent on himself using his mother durable power of attorney. In each case the federal court focused on IRC 408(d)(1) which provides that *"any amount paid or distributed out of an individual retirement plan shall be included in gross income by the payee or distributee."* In each of these cases, the IRA funds were distributed to the IRA owner, i.e., personally received by the parent, even though the child enjoyed the benefit of the IRA distributions. Because there was no forgery involved in either case, i.e. the parent was misled by their child's representations of the need to take IRA distributions, IRC 408(d)(1) applied to cause the parent to pay the income tax liability. Added to the Gomas's misery was the fact that the 2017 Tax Act eliminated any theft loss deduction between 2018 and 2025.

Lack of Remedies: There are few practical remedies available to these victims of elder or financial abuse. In the Gomas's case, the daughter is spending the next 25 years in a federal prison, and her parents are likely to be long dead by the time she is released. And surprisingly, neither theft nor fraud are included in the list of situations where an account owner's self-certification allows an extension of the 60-day rollover deadline to replenish the IRA.

Restorative Payments: To address this gap in remedies, the IRS has come up with what it calls the restorative payment doctrine.

- PLRs: Back in 2004 the IRS published 11 related private letter rulings that permitted lawsuit settlement amounts to be rolled over to IRAs. [PLRs 20045043, 44,45,46,48,49,50,51,52,53 and 54.] In each of these situations the account owner had sued an insurance company for improperly selling them annuities for their IRAs; each account owner subsequently received a settlement amount from the insurance company. The IRS in each private letter ruling allowed the owners 60 days from the date of their receipt of the settlement funds to complete their rollovers to their respective IRAs.

  60-Day Waiver: In yet another private letter ruling [PLR 200512035] the IRS allowed a settlement received from a financial advisor who stole the nursing home resident's IRA funds to roll the settlement amount back into the owner's IRA. The IRS relied on IRC 408(d)(3)(1) to allow the 60-day rollover deadline to be waived where its failure to do so would be "*against equity or good conscience.*"

  Not *Rollovers:* The IRS in subsequent PLRs changed its wording referring these permitted contributions to IRAs to be called restorative payments, i.e., replacements for losses, and not as *rollover contributions.* With this distinction, the IRS avoids treating the payments to the IRA as an excess IRA contribution if the amount exceeds the IRA contribution dollar limitation, or the funds were contributed more than 60 days later.

  Restorative Limitations: There are still limits to the IRS's leniency. This contribution latitude is only with regard to restoring some or all of the losses that result from a breach of fiduciary duty, fraud, or federal or state securities violations. Compensatory damage awards are thus the focus of a *restorative payment.* But neither punitive damages nor an attorneys fee award fall within a *restorative payment* concept. And stating the obvious, the *restorative payment* opportunity to replenish a depleted IRA is not available to make up for investment losses. Any settlement amount, either through litigation, arbitration, or a direct settlement can be the subject of a *restorative payment.*

Conclusion: Since remedies are limited, we need to be vigilant when monitoring distributions from retirement accounts on behalf of clients, especially the elderly.