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

CC:EBEO:Br7

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MEMORANDUM FOR

FROM: CHIEF, BRANCH 7, OFFICE OF ASSOCIATE CHIEF COUNSEL (EMPLOYEE BENEFITS & EXEMPT ORGANIZATIONS) (CC:EBEO:BR7)

SUBJECT: REVIEW OF ADVISORY OPINION CONCERNING IRA DISTRIBUTIONS

This Field Service Advice is in response your request for our views regarding your memorandum to Chief, Examination Division,
. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. Field Service Advice issued to Examination or Appeals is advisory only and does not resolve Service position on an issue or provide the final basis for closing a case. This document is not to be relied upon or otherwise cited as precedent.

LEGEND:

X =
Y =

ISSUES:

Whether the Service has the authority to waive the 60-day rollover rule of I.R.C. § 408(d)(3)(1) and the early distribution tax under section 72(t).

CONCLUSION:

The Service does not appear to have the authority to waive either the 60-day rollover rule of section 408(d)(3)(1) or the early distribution tax under section 72(t) under the circumstances of this case.

FACTS:

X, an individual doing business under the name Y, provided accounting services primarily with respect to estate and trust work. Between 1989 and 1997, X, in addition to providing legitimate accounting services, misappropriated funds from 22 clients, friends, and relatives by convincing them to make investments in either a partnership venture or a mutual bond fund and subsequently embezzling their money. Many of X's victims obtained funds for the investment by making withdrawals from qualified tax deferred accounts such as IRA's, and apparently believed that the new investments would receive tax-free rollover treatment.

On January 6, 1999, after being the target of a criminal tax investigation, X pled guilty to mail fraud and income tax evasion based on the unreported embezzlement income. Until recently, X's victims were unaware that he had defrauded them. After learning of the embezzlement, the victims contacted the special agent on the case regarding the tax consequences stemming from their lost investments. It is unknown whether X spent all the embezzled funds or whether a portion of the funds is available to satisfy claims of the defrauded investors.

LAW AND ANALYSIS:

In your memorandum to the Examination Division, you conclude that the Service should waive the 60-day rollover period for those taxpayers whose funds were embezzled if they replenish their IRAs with funds from other sources within a reasonable time. In reaching this conclusion, you rely upon Wood v.Commissioner, 93 T.C. 114 (1989), Childs v. Commissioner, T.C. Memo. 1996-267 (1996) and PLR 9234016. Based upon the facts presented, the taxpayers' situation appears to be distinguishable from this authority, and we do not believe that the Service has the authority to waive the rollover period absent additional facts that bring the taxpayers within the ambit of Wood. [1] We similarly believe that there is no basis to waive the additional tax for early distributions under section 72(t). Our reasons are discussed below.

In Wood, the taxpayer received a lump sum distribution and stock shares from a profit sharing fund. The taxpayer met with an account executive of a national brokerage firm where he had an existing non-IRA account in order to establish an IRA into which he could roll over the distribution. The taxpayer signed

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[1] We believe that further factual development is necessary to resolve each case. For example, it is not evident from the information that we have whether X held himself out as a nonbank trustee. In addition, we do not know whether the taxpayers signed any documents opening an IRA or took any other reasonably prudent steps to insure that the rollover was accomplished. The burden is on the taxpayer to prove what reasonable steps each took to accomplish the rollover.

documents to establish the IRA and instructed the account executive to deposit the lump-sum distribution into the IRA. The taxpayer physically delivered the lump sum distribution check and stock certificates to the account executive at that time. The brokerage firm's records indicated that a portion of the distribution was recorded as having been transferred to the other account that the taxpayer maintained with the brokerage firm. Four months after the expiration of the 60-day period allowed for rollover, the brokerage firm corrected its records to reflect transfer of the remaining portion of the distribution to the IRA. The court held that under these circumstances, the 60-day rollover period of section 408(d)(3) was satisfied because the money was delivered to the trustee of a valid IRA rollover account and the failure by the brokerage firm to record the transfer was a mere bookkeeping error.

In Childs, the taxpayer opened two IRA accounts with a bank and deposited a distribution which she later learned was not eligible for tax-free rollover treatment. In order to qualify for relief under section 408(d)(4), the taxpayer was required to withdraw the excess contributions on or before August 15th of the year at issue. Although the taxpayer verbally instructed the bank to convert her IRA account into a non-IRA account, this request was not completed by the bank until after August 15th. The delay was the result of a failure on the part of the taxpayer to complete necessary documentation. However, the court found that the taxpayer had exercised diligence in phoning the bank, and had been misled by a bank employee into believing that it was not necessary to execute any bank documents to convert the account. The court held that since the taxpayer took all necessary steps to withdraw the excess funds by the required date, relief should be granted.

PLR 9234016 dealt with the tax consequences of embezzlement by a bank officer. The officer had issued worthless certificates of deposit to account holders in exchange for funds. The bank reimbursed depositors who could demonstrate that they had made deposits for the purchase of worthless certificates. The Service ruled that amounts restored to the depositors' IRA's were not taxable to depositors.

In our view, two facts distinguish the taxpayers at issue from the taxpayers in the cases and ruling cited above. First, the taxpayers at issue have not established that they were dealing with an individual that they had a reasonable expectation to believe had the authority to establish an IRA, such as an employee of a bank or a financial institution. Although the facts indicate that X provided accounting services, there is no mention of his qualifications as an IRA trustee. In Wood, Childs and PLR 9234016, the taxpayers were each dealing directly with individuals who were employees of financial institutions and therefore would have met the qualifications for IRA trustees within the meaning of section 408(a)(2). Second, although the facts indicate that the taxpayers at issue believed that the money would be deposited into accounts that would qualify for tax-free rollover treatment, there is no evidence that they ever took the steps required to set up these accounts. Rather, it appears that the taxpayers merely gave their money to X and requested that he invest it for them. This fact distinguishes the taxpayers at issue from the taxpayer in Wood, who had completed the paperwork necessary to establish the IRA rollover account, and from the taxpayers in Childs and PLR 9234016, who maintained accounts at the institutions that effectuated the transfers.

Although you have drawn an analogy between the instant case and Wood, we believe that the holding in Schoof v. Commissioner, 110 T.C. 1 (1998) actually controls. In Schoof, the Tax Court held that where a taxpayer gives a distribution intended as a rollover to a trustee who is not qualified under section 408(a)(2), rollover tax treatment is denied, and the taxpayer must include the distribution in income. In reaching this decision, the court specifically held that Wood was distinguishable because it merely involved “procedural defects 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. The court also held that based upon the legislative history of section 408(a)(2), individuals are per se ineligible to serve as trustees for IRA trusts. In the present case, it is unlikely that X could be considered a qualified trustee since he appears to have acted in an individual capacity, even though he did business under the name Y. Accordingly, under the holding of Schoof, the taxpayers who gave him distributions failed to satisfy a fundamental statutory requirement, and should be required to include the amount of the distribution in income. This result is not changed simply because X embezzled the funds.

Even if X were considered to be a qualified trustee, Orgera v. Commissioner, T.C. Memo. 1995-575 demonstrates that although a taxpayer may believe that he has done everything necessary to effectuate a rollover, the 60-period is nevertheless strictly construed. In Orgera, the taxpayer deposited his pension distribution in a money market account at his company's credit union and argued that he should receive tax-free rollover treatment because he believed he was making a qualified IRA deposit. In Orgera, as in Schoof, the court specifically declined to extend the Wood rationale, and denied rollover treatment since the taxpayer failed to make a timely transfer of the distribution to an IRA that met the statutory requirements. Similarly, despite their intentions, the taxpayers in the present case failed to meet the statutory requirements necessary to achieve rollover treatment.

In addition to the above cited cases, one private letter ruling supports our finding that there is no legal basis for the Service to waive the rollover requirements or early distribution tax in this case. PLR 8815036 involved a taxpayer who gave IRA funds to an embezzler with the mistaken expectation that the funds would be deposited to a qualified retirement plan within 60 days. In this ruling, which is directly analogous to the instant case, the Service denied rollover treatment even though the taxpayer deposited the funds to the plan after they were recovered because the 60-day period was not met. In support of its position, the Service states:

> The Code does not provide relief from applicable taxation where the taxpayer intended to rollover funds from one IRA to another, and in fact fails to do so or places the funds in an investment vehicle other than an IRA. Therefore, the transfer of funds to an individual instead of an IRA does not constitute a complete and timely rollover.

In PLR 8815036, the Service also ruled with respect to section 72(t) that the 10% additional tax applied because none of the exceptions were satisfied. We believe that this is the correct conclusion.

In our view, there is no legal basis to waive the additional tax for early distributions under section 72(t) in the instant situation unless the taxpayers meet one of the exceptions set forth in the statute. Although you cite Larotonda v. Commissioner, 89 T.C. 287 (1987) and Murillo v. Commissioner, T.C. Memo. 1998-13 in support of the theory that section 72(t) tax should be waived where a distribution is involuntary, the Service has specifically declined to adopt the position that section 72(t) tax should be waived in instances of involuntary distributions.[2] Even if the Service applied this standard, however, the fact remains that these taxpayers voluntarily withdrew funds from their IRA's and transferred those funds to X. This distinguishes them from the taxpayer in Larotonda, whose distribution was the result of a levy, and the taxpayer Murillo, who forfeited his IRA to the government as part of a plea agreement.

In summation, based on the facts presented, we see no legal basis for relief with respect to the rollover issue because the taxpayers' situation appears to be distinguishable from those cases and private letter rulings that disregard a taxpayer's failure to follow literal statutory requirements. In addition, the requirements articulated by the court in Schoof do not appear to be satisfied. The taxpayer's situation appears similar to Orgera where the court declined to grant

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[2] The Service published AOD CC-1988-010 on April 11, 1988 indicating non-acquiescence with Larotonda and stating that the under the rationale of In re Kochell, 804 F.2d 84 (7th Cir. 1986), the premature distribution tax applies to distributions regardless of whether they are voluntary. On January 29, 1999, the Service published AOD CC-1999–002, which withdraws the earlier Larotonda AOD due to statutory changes to section 72(t) brought about by the Restructuring and Reform Act of 1988, Pub. L. No. 105-206, 112 Stat. 685 (1998) that will be effective for distributions after December 31, 1999. However, the withdrawal does not alter the Service's position with respect to whether a voluntary/ involuntary standard should apply. On January 29, 1999 in AOD 1999-003, the Service acquiesced in result only in response to Murillo v. Commissioner, T.C. Memo. 1998-13. The AOD specifically states that although the Service will not assess section 72(t) tax under the narrow circumstances of Murillo, in all other cases involving early distributions, the Service will continue to assess section 72(t) tax unless a statutory exception applies.

relief even though the taxpayer intended to make a tax-free rollover. However, if any of the taxpayers are able to prove additional facts that would narrow the distinction between their case and Wood, we should consider such facts carefully. Barring such a showing, the Service must operate within the existing statutory framework if it is to fairly, consistently and effectively administer the Internal Revenue Code.

Please contact Christine Keller at (202)622-2311 with any questions.

MICHAEL J. ROACH