IRA UPDATE: JANUARY 2012

Important IRA Rulings from 2011

Paschall Case:

This case arose from a questionable Roth IRA conversion going back to 2000. The statute of limitations regarding the distribution and subsequent conversion to the Roth IRA has passed by the time the IRS got wind of the transaction and therefore owed no income tax on the transfer, so IRS took a different approach; they went after the taxpayer for over 8 years of excess contribution penalties to the Roth IRA. The ruling is significant because the statute of limitations was not considered to have begun because the taxpayer had not filed the IRS form 5329 (Additional tax on IRAs, other qualified plans, etc.) that would normally be required to be filed if there were and excess contribution to an IRA. The 5329 is considered a return all on its own and had the taxpayer included the form along with the regular tax return indicating no penalty was due, the statue of limitations would have begun and the IRS would not have had a case. The moral of the story is that the 5329 should be filed with a tax return especially if a questionable Roth conversion is done. Of course one should consider the merits of any questionable Roth conversion strategies or strange tax shelters first.

Mandelbaum Case:

This case arose from losses attributable to self-directed IRAs that were invested with Bernie Madoff. The issue the plaintiffs argued is that the custodian of the self-directed IRA had a fiduciary duty to protect the assets from theft. As a reminder, a self-directed IRA allow the investor to make non-traditional investments in their IRA and often is the case that the self-direct IRA custodian does not provide such protections that would normally be expected in an IRA invested in traditional asset types. Those protections are often limited to recordkeeping and compliance with regulations. Thus in this case, the defendant was not liable for losses because the plaintiffs, not the custodian, made the decision to invest with Madoff. The moral here is that custodians may not be liable for losses, even in the event of theft. Caution should always be used when investing in a self-directed IRA as there are so many pitfalls that can blow up the IRA completely.

Willis v. Menotte:

This was a bankruptcy where the defendant asserted that his $1.5 million IRA was exempt from creditors in the bankruptcy proceeding. Normally this argument would hold however the IRA owner had engaged in prohibited transactions thus opening the door to creditors. Not only was the IRA subject to claims of the creditors, but also other IRAs which were funded from the “tainted” IRA.

PLR 201129045

Taxpayer was granted relief to complete a 60 day rollover after receiving bad advice from her financial advisor and financial firm. She wanted to transfer her IRAs to a grantor trust and while the advisor learned that an IRA cannot be owned by a trust, the advisor instead distributed the RIA to a non-IRA account held by the trust. The IRA owner did not realize this was a taxable event until well after the 60 day window had passed. This case highlights the problems that can arise when working with uneducated advisors. Fortunately for the IRA owner, IRA has automatic waiver for cases that can be shown were a result of advisor/firm error or bad advice. Also the fees for Private Letter Rulings can be quite expensive and in cases where the automatic waiver exists, the PLRs may not have been necessary as there is already a framework for correcting these mistakes.

These are just a few of the many IRA related cases and IRS Private Letter Rulings that occurred throughout the year. The key with IRAs is that the tax code is complex and you should be sure you are working with an advisor competent in this area.

As always, feel free to contact me directly to ask any questions you may have on these topics.

Sincerely,

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