PERSPECTIVE

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You Stole My Pension Money Pay Up, Taxes Too

By Robert W. Wood

Legal disputes come in all shapes and sizes. And there are almost always tax issues that face plaintiffs, defendants, or both. Plaintiffs receiving money worry if and how it is taxable, whether they can deduct or offset their attorney fees, and more. Even without the special and complex rules governing qualified pension and retirement plans, the tax treatment of a legal settlement can be daunting.

Suppose that your employer, broker, or money manager mismanages or takes your pension funds? You sue (or arbitrate) to get it back. If it was originally in a tax-qualified pension plan, can you put it back into the plan or into an IRA? Will the IRS allow that without penalizing you, or once it is removed, are the tax benefits gone for good?

Just how would this be done, anyhow? And does putting it back mean putting all of the money back, including the portion you might pay a contingent fee lawyer? Or will you be taxed on that part? You might think that these questions have simple answers. But as with so much else in the tax law, they are not so simple after all.

Let's start with the notion that the pension provisions of the Internal Revenue Code are complex. There are extensive tax rules governing qualified pension, profit sharing, and stock bonus plans maintained by an employer for its employees. There are many tax benefits these plans offer. The employer can write off the contributions to the plans, even though it is clear the money will stay in the plan for years and not be taxed to participants until later.

The income earned on funds while held by the plan is not taxed. Plus, the participant is not taxed on the money until he or she receives a distribution, usually after retirement. And since these are also employment provisions, there are Department of Labor rules too. For example, employee plan contributions cannot discriminate in favor of highly compensated employees.

There are limitations on the deductibility of employer contributions. And there are limitations on contributions and other additions to the accounts of plan participants. If there are contributions that go over the amount that can be deducted, the IRS imposes a 10% excise tax. There are plenty of other technical rules too.

Against this complex backdrop, if your pension is looted or mismanaged and you receive a settlement, can you put it back and sidestep the tax? There is not much tax authority, and it is complex. The short answer is that you may be able to put it back in the plan and sidestep the tax, but you have to be careful. The IRS has attempted to address some of these nuances in rulings.

In Revenue Ruling 2002-45, 2002-2 C.B. 116, the IRS considered whether certain payments could be treated as pension contributions and therefore not taxed. The employer in the IRS ruling invested an unreasonably large portion of the plan's assets in a high-risk investment that later became worthless. The IRS considered two fact patterns.

In Situation 1, the plan participants filed suit against the employer for breach of fiduciary duty in connection with the high-risk investment. The parties reached a court-approved settlement. The employer did not admit the breach of fiduciary duty, but agreed to make a payment to the plan equal to the losses (including an appropriate adjustment to reflect lost earnings). The payment was allocated among participant accounts in direct proportion to their shares of the high-risk investment.

Situation 2 was similar, except that in this case the participants did not file a lawsuit against the employer. Rather, the employer learned that the participants were considering legal action. The employer reasonably determined, based on the circumstances, that it had a reasonable risk of liability for breach of fiduciary duty. It then opted to make the payment before a lawsuit was filed.

Considering both situations, Revenue Ruling 2002-45 says that a payment made to a plan to make up for losses due to market fluctuations that are not attributable to a breach of fiduciary duty is a contribution, subject to numerous limits. Conversely, a "restorative payment" is a payment made to a plan to restore losses from fiduciary breaches under ERISA. Amounts exceeding the losses are not restorative. Payments that treat similarly situated plan participants differently are also not restorative.

The IRS determined that the payments made in both Situations 1 and 2 were restorative payments so were not taxed. And as restorative payments, the normal plan limitations would not apply. How about an Individual Retirement Account? IRS Letter Ruling 200921039 considered some of these issues stemming from a payment made to an individual's IRA.

A 77-year-old taxpayer had an IRA maintained by Company A. Company A discovered that one of its employees had made several unauthorized distributions from the taxpayer's IRA, totaling "Amount D." Company A and the taxpayer settled, with Company A agreeing to pay Amount D back to the IRA. The IRS considered whether Company A's payment of Amount D to the IRA was a "restorative payment," not subject to restrictions on contributions and rollovers.

The IRS also considered whether a reasonable amount of interest could be considered part of a restorative payment. Eventually, the IRS determined that the settlement was a restorative payment. However, the IRS ruled that the interest would not be a restorative payment. According to Revenue Ruling 2002-45, payments to a defined contribution plan should be treated as contributions if they merely replenish a participant's account after investment losses. Conversely, payments made to restore account losses due to an action (or failure to act) that creates a reasonable risk of liability are restorative payments. Using this reasoning, Letter Ruling 200921039 made clear that payments to an IRA to restore losses resulting from breach of fiduciary duty, fraud, or federal or state securities violations would also constitute restorative payments.

The IRS concluded that Company A's payment of Amount D to the IRA constituted a restorative payment. However, Revenue Ruling 2002-45 limits the amount of a restorative payment to the amount of loss that occurred as a result of the breach of fiduciary duty. Thus, the IRS ruled that

any interest on Amount D would not be considered a restorative payment.

Tax law is technical, and pension law is arguably even more so. So be careful, and any time you are trying to recover qualified pension or IRA losses, get some help. Sometimes a word here or there in your documents can make a big difference.

Robert W. Wood *is a tax lawyer with www.WoodLLP.com, and the author of "Taxation of Damage Awards & Settlement Payments" (www.TaxInstitute.com). This is not legal advice.*