

July 26, 2010

MEMORANDUM TO CLIENTS

RE: IRS Issues Guidance on Basis Reporting Errors

The IRS recently issued unofficial guidance on Form 1099-R reporting error due to failure to take into account a participant's basis for annuity payments received from a section 401(a) qualified plan. Specifically, private letter ruling 201021042 addresses the proper basis recovery where the Form 1099-R incorrectly stated that the taxable amount in box 2a was the gross amount paid to the participant, and the participant failed to exclude any portion of the payments from taxation on Form 1040. (Presumably, the "taxable amount not determined" box was not checked, and/or the amount of the basis recovered for the year was not reported in box 5.)

As anticipated, the IRS reiterated the general basis recovery method for periodic payments made from a qualified plan, called the Simplified Method under Code section 72(d). Under this method, as of the annuity starting date, the monthly excludable amount is determined by dividing the investment in the contract (i.e., after-tax contributions) by the applicable divisor under the Code (which is based off the ages of the participant and joint annuitant at the annuity starting date). For any tax years that remain open (generally a 3 year statute of limitations), the participant was entitled to claim a refund for taxes paid on the recovery of the basis. However, no recovery was available for the prior years.

Importantly, the IRS specifically rejected the following correction approaches as having no legal basis: (1) treat the entire pension payments as non-taxable for the open tax years until you have recovered the missed basis, or (2) treat the earliest open tax year as the annuity starting date and compute the exclusion amount based on that assumption (e.g., uses the ages as of the earliest correction year).

Accordingly, the participant was entitled to file an amended return (e.g., Form 1040-X) for the open tax years (e.g., 2007 forward) to exclude a portion of the pension payments based on the Simplified Method that should have been calculated when payments commenced, and was also permitted to exclude in the current year (and future years) the yearly excludable amount until the investment in the contract is fully recovered. Presumably, the basis that should have been excluded in the closed years can be excluded by the surviving joint annuitant (and if not fully recovered on death, then can be taken as a final deduction for the last annuitant).

For example, when payments commenced in the form of a joint and survivor annuity in 2002, the participant and the annuitant were ages 51 and 44 (sum of 95), and the divisor for less than 111 is 410. If we assume that after-tax contributions were \$41,000 and the participant was receiving \$2,000 a month, the monthly exclusion is \$100, and \$1,200 of the \$24,000 is excludable each year (2007 forward) until the full \$41,000 is recovered.

Notably, the ruling is focused on the participant's tax treatment and does not address any applicable reporting penalties imposed on the plan administrator for failure to properly report the payments. However, this ruling is instructive for understanding the lack of flexibility in correcting basis recovery errors.

* * *

Author: Elizabeth T. Dold

If you have any questions, please contact your regular Groom contact or any of the attorneys listed below:

Elizabeth T. Dold	edold@groom.com	(202) 861-5406
David N. Levine	dlevine@groom.com	(202) 861-5436
Mark L. Lofgren	mlofgren@groom.com	(202) 861-6614
Louis T. Mazawey	lmazawey@groom.com	(202) 861-6608
David W. Powell	dpowell@groom.com	(202) 861-6600