

# Caution on lump sum payouts

A taxpayer, let's call him Bob, left his job and received a lump sum payout of his pension accumulation. Let's say that the payment was \$100,000. To protect his retirement nest egg, Bob rolled the entire amount over to an IRA. Unfortunately, and unbeknownst to Bob, there had been a serious mistake by the pension plan administrator in calculating his lump sum, and Bob was paid more than he was due. Years later, when the mistake was discovered, Bob was required to repay \$20,000 to the pension plan. He took the money for the repayment from his IRA rollover.

Tax consequences?

For Bob, there are three separate tax problems here, according to the IRS Chief Counsel Advice that analyzed the situation.

First, Bob was only eligible to roll \$80,000 into the IRA the year that he received the lump sum distribution, even though he had no way of knowing that. The excess \$20,000 should have been included in his taxable income that year. However, in the fact pattern the IRS stipulates that so much time has elapsed since the rollover that a collection of that tax is now barred by the statute of limitations.

Second, the extra \$20,000 rolled into the IRA is subject to a 6% annual excise tax until it is "absorbed" or offset by later IRA contributions not made. Let's say that in the year after the rollover, Bob was eligible to set aside \$5,000 in an IRA, but he made no contribution that year. The "excess" in the rollover then is reduced from \$20,000 to \$15,000, and so on each year until it is covered. But if Bob made a contribution of, for example, \$3,000 in the second year, only \$2,000 of the excess would be absorbed, leaving \$18,000 exposed to the continuing 6% annual penalty.

Finally, the \$20,000 that Bob withdrew from his IRA to repay to the pension plan must be included in his taxable income in the year of the withdrawal. That would be consistent with the way Bob reported the rollover the year he received the lump sum, and he can't change that now that the statute of limitations has expired. However, if the problem had come up earlier, before the statute of limitations had expired, Bob might have been able to mitigate the problem through a corrective procedure in the tax code.

Also, Bob will be able to take a tax deduction for the repayment, but that will be a miscellaneous deduction. These are only deductible to the extent that they exceed 2% of adjusted gross income.

What should someone in Bob's situation do? Ideally, in the year of the lump sum distribution, an independent actuary should be consulted to confirm the accuracy of the calculations.