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Steve Leimberg's Employee Benefits and Retirement Planning Email Newsletter Archive Message #679

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Subject: Mary Vandenack on *McGaugh v. Commissioner* - Seventh Circuit Finds No Taxable IRA Distribution Where Taxpayer Wired Funds to Purchase Stock IRA Custodian Refused to Accept

"Raymond McGaugh maintained an IRA at Merrill Lynch. In 2011, Raymond sought to purchase shares in First Personal Financial Corp. with funds in his IRA. McGaugh initiated a wire transfer from his Merrill Lynch IRA for purposes of purchasing such shares. When Merrill Lynch received the stock certificate for shares of First Personal Financial Corp., the stock certificate was mailed to an incorrect address for McGaugh. Merrill Lynch treated the transfer of funds for purchase of such shares as a taxable distribution and issued McGaugh a 1099-R. The Tax Court ruled that no taxable distribution occurred because McGaugh was never in actual or constructive receipt of the IRA funds. The Seventh Circuit Court of Appeals agreed."

Mary Vandenack provides members with her commentary on McGaugh v. Commissioner. Mary had the pleasure of acting as counsel for McGaugh at the Seventh Circuit Court of Appeals.

Mary E. Vandenack is founding and managing member of **Vandenack Weaver LLC** in Omaha, Nebraska. Mary is a highly-regarded practitioner in the areas of tax, benefits, high net worth estate planning, asset protection planning, executive compensation, business succession planning, tax dispute resolution, international tax, state and local tax, and tax-exempt entities. Mary's practice serves businesses and business owners, executives, real estate developers and investors, health care providers and tax exempt organizations. Mary is a member of the American Bar Association Real Property Trust and Estate Section where she serves as Co-Chair of the Futures Task Force and chair of the Technology and Economics of Law Practice Committees. Mary is also active in the American Bar Association Law Practice Division where she serves on the TechShow Board, the Executive Council, and the Law Practice Magazine

Board. Mary is also a member of the American Bar Association Sections on Taxation and Business. Mary is a frequent writer and speaker on tax, benefits, asset protection planning, and estate planning topics as well as on law practice related topics including improving the delivery of legal services, technology in the practice of law, building sustainable law firms, and alternative fee structures.

Here is her commentary:

EXECUTIVE SUMMARY:

Raymond McGaugh maintained an IRA at Merrill Lynch. In 2011, Raymond sought to purchase shares in First Personal Financial Corp. with funds in his IRA. McGaugh initiated a wire transfer from his Merrill Lynch IRA for purposes of purchasing such shares. When Merrill Lynch received the stock certificate for shares of First Personal Financial Corp., the stock certificate was mailed to an incorrect address for McGaugh. Merrill Lynch treated the transfer of funds for purchase of such shares as a taxable distribution and issued McGaugh a 1099-R. The Tax Court ruled that no taxable distribution occurred because McGaugh was never in actual or constructive receipt of the IRA funds. The Seventh Circuit Court of Appeals agreed.

FACTS:

Raymond McGaugh maintained an IRA with Merrill Lynch. In 2011, McGaugh requested Merrill Lynch purchase 7,500 shares of stock of First Personal Financial Corporation ("FPFC") with funds held in his IRA. At that time, Merrill Lynch already held 10,000 shares of FPFC stock as custodian in a retirement account for McGaugh.

About October 7, 2011, Merrill Lynch processed a wire transfer, of $50,000 to FPFC. The wire transfer had been requested by McGaugh. Following receipt of the wire transfer, FPFC issued stock certificate number 253 dated November 28, 2011, for 7,500 shares of FPFC common stock. The Stock Certificate was issued in the name of McGaugh's IRA as "RAYMOND MCGAUGH IRA FBO RAYMOND MCGAUGH". The Stock Certificate was mailed to Merrill Lynch as custodian of the IRA. Merrill

Lynch acknowledges receipt of the Stock Certificate but alleges it was not received until January 19, 2012.

Following receipt of the Stock Certificate from FPFC, Merrill Lynch twice sought to mail the Stock Certificate to McGaugh but used incorrect addresses both times. At the time of trial in the Tax Court, it was unclear where the actual stock certificate was located. The location of the Stock Certificate remains unknown. FPFC has refused to issue a replacement certificate absent receipt of an affidavit of lost stock certificate from Merrill Lynch as custodian.

An email from a Merrill Lynch vice president indicated that the reason that a 1099-R was issued to McGaugh was based on the shares not being deposited into the IRA account within the “60 days allowed under IRS regulations to consider the withdrawal non-reportable.”

The 1099-R issued by Merrill Lynch was mailed to the same incorrect address to which Merrill Lynch unsuccessfully attempted to deliver the Stock Certificate. The 1099-R was not received by McGaugh. As a result of the issuance of the 1099-R, the Commissioner issued a Notice of Deficiency on March 17, 2014, indicating that McGaugh failed to report $50,000 of retirement distributions for the 2011 tax year. The Commissioner determined that tax and penalties were due.

McGaugh filed suit in the Tax Court. The Tax Court, on motion for summary judgment by McGaugh, agreed with McGaugh’s position that there was no taxable distribution to McGaugh. The Seventh Circuit affirmed.

COMMENT:

Internal Revenue Code §408(d)(1) provides that “Except as otherwise provided in this section, any amount *actually paid or distributed or deemed paid or distributed from* an individual retirement account or individual retirement annuity shall be included in the gross income of the payee or distributee for the taxable year in which the payment or distribution is received.”

The Tax Court addressed the issue of whether there was actual receipt of funds by McGaugh. The Tax Court concluded that because no cash, check, or wire transfer ever passed through McGaugh's hands, he was not a literal payee or distribute.[i] Thus, no actual distribution occurred. The Seventh Circuit did not specifically address the actual receipt issue but focused on the issue of constructive receipt.

The Seventh Circuit noted that the core issue in determining whether a taxable distribution occurred depended on whether McGaugh was in "constructive receipt" of his IRA funds. The constructive receipt doctrine recognizes as income such income that is constructively received by a taxpayer as a result of amounts being set aside for the taxpayer or otherwise made available to the taxpayer.[ii] A key factor in determining whether there is constructive receipt is "when the economic value is within the taxpayer's control."[iii] The Seventh Circuit noted that there was no evidence that McGaugh had any control over the shares or the rights associated with such shares.

The Internal Revenue Service made an interesting argument by claiming that McGaugh constructively received the funds when he made the direction to purchase stock from his IRA. In fact, the Internal Revenue Service suggested that the purchase of stock in an IRA was analogous to purchasing an automobile. The Seventh Circuit recognized that McGaugh's effort to purchase stock could not be construed as an effort to make a distribution to himself via a third party. The Seventh Circuit stated "McGaugh didn't direct a distribution to a third party; he bought stock."

The Internal Revenue Service also sought to establish a taxable distribution to McGaugh on the basis that McGaugh was acting as a conduit for Merrill Lynch in making a transfer to purchase stock. The Tax Court concluded that even if the taxpayer pulled all the strings in directing the stock purchase, the funds went directly from the IRA to the investment. As a result, there was no taxable distribution.[iv] The Seventh Circuit did not address the conduit argument.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Mary Vandenack

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McGaugh v. Commissioner, No. 16-2987 (7th Cir. 2017).

CITATIONS:

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[i] *McGaugh v. Commissioner*, T.C. Memo 2016-028.

[ii] 29 C.F.R §1.451-2(a).

[iii] *United States v. Fletcher*, 562 F. 2d 839, 843 (7th Cir. 2009).

[iv] *McGaugh v. Commissioner*, T.C. Memo 2016-028.