The Kiplinger Tax Letter

CIRCULATED BIWEEKLY TO BUSINESS CLIENTS SINCE 1925

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Dear Client: Washington, Aug. 1, 2024

HIGHLIGHTS

- Tax Credits Kidney donation
- Direct File More states signing on
- Business Taxes Stock sale to ESOP
- Tax Disputes No innocent spouse
- Bankruptcy Retirement plan
- Enforcement IRS Appeals office

IRS finally provides clarity on inherited IRAs... almost five years after Congress curbed stretch IRAs for many beneficiaries. Before 2020, IRA owners could leave their accounts to their kids, grandkids, etc., and heirs could stretch RMDs over their lifetimes. Congress saw this as a loophole and curtailed it.

There's a 10-year clean-out requirement. It applies to many IRAs inherited after 2019. Funds must be distributed within 10 years after death. So, if an IRA owner dies in Oct. 2024, the beneficiary must clean out the IRA no later than Dec. 31, 2034.

Eligible designated beneficiaries are exempt from the 10-year rule. This applies to surviving spouses or minor children (until age 21), the chronically ill or disabled, and people who are not more than 10 years younger than the decedent. They can still do stretch IRAs. Ditto for individuals who inherited IRAs before 2020. A surviving spouse also has the option to take the inherited IRA as his or her own.

IRS's final regulations explain how the inherited IRA 10-year rule works... And, to the dismay of many, keeps a controversial distinction in place: Whether an IRA owner dies before or after his or her RMD beginning date. If the owner dies before, then beneficiaries needn't take annual payouts. They can opt to wait until year 10 to take the money, get yearly distributions, or skip years, provided the IRA is fully depleted by the end of the 10-year period.

If the owner dies on or after the RMD start date, annual payouts are required. Beneficiaries must take yearly RMDs over the 10-year period, beginning with the year after the original IRA owner died. This means RMDs must be paid to the beneficiary in years 1 through 9, with the rest of the account fully depleted by year 10. In this situation, the beneficiary figures annual RMDs based on his or her own life, so the younger the beneficiary, the smaller the yearly RMD amounts. Of course, the beneficiary can withdraw larger amounts from the IRA if he or she so chooses.

There's relief if the IRA owner died in 2020, 2021, 2022 or 2023. Beneficiaries of IRAs in which the original owner was already subject to RMDs won't be penalized for not taking payouts in 2021-24. They needn't make up for the missed distributions. In figuring the 2025 RMD, they start with the life expectancy factor that applied to the beginning of the 10-year period and subtract one for each subsequent year. For example, a beneficiary inherits an IRA in 2021, the 10-year clean-out rule applies, the decedent started taking RMDs before death and the beneficiary didn't take RMDs in 2022, 2023 or 2024. Under IRS's final rules, the beneficiary needn't make up for the three years of missed RMDs. He or she must take only seven years of RMDs, starting with the first payout in 2025, and clean out the account by the end of 2031.

Beneficiaries of Roth IRAs are also subject to the 10-year rule... With two key differences. They needn't take annual RMDs over 10 years. Also, similar to Roth IRA owners, Roth beneficiaries aren't taxed on distributions.

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TAX CREDITS

If you're getting subsidies for health coverage bought on an exchange... Notify the exchange of changes that could affect the health premium credit. This could include changes in family size, household income and other circumstances, such as starting a job with an employer that provides health coverage to employees. For example, if you lost a job, the exchange will hike the subsidy for future months. It will lower the subsidy amount if you let it know you expect higher income in 2024. If your 2024 income ends up being higher than estimated when you bought your policy, the health premium credit that you figure on your Form 1040 next year may be lower than the advance premiums you got, leading to a smaller refund or even a tax bill.

Filers who faultily report health premium credits are IRS audit targets.

Would a large tax credit entice you to donate your kidney to a stranger? Then you might be interested in this idea from the Coalition to Modify NOTA, an advocacy organization that highlights the need for kidney donations to strangers. Its proposal, the End Kidney Deaths Act, would establish a 10-year pilot program to give a refundable $50,000 tax credit...$10,000 over five years...to living donors who donate a kidney to a stranger. The donated kidneys would go to patients who have been waiting the longest on the kidney transplant waitlist. The group touting this proposal says that it could save taxpayers billions in health care costs. The group has been lobbying Congress and the states to consider such a proposal.

PAYROLL TAXES

Amended employment tax returns can now be filed electronically, IRS says. Employers can e-file Forms 941-X, 943-X, 945-X as well as amended 940s. If amending the 940, be sure to check the amended return box on the top of the form.

IRS

IRS online account holders have an easier time knowing their audit status. Individuals who set up such accounts with IRS and are under examination can now view information about their audit status instead of having to call the agency.

Among other features of such accounts: You can access tax transcripts, get digital copies of some IRS notices, and view refund status as it's being processed. People who owe federal taxes can see their balances, review payment plan options, complete pending installment agreements, make payments or cancel future payments, get virtual assistance, access lien information, and use a lien payoff calculator.

Republican lawmakers are back to their old ways in wanting to starve IRS. GOP House appropriators have proposed a $2 billion cut in annual funding for the agency for 2025. Although it has House support, it won't pass the Senate. Congress gave IRS $12.32 billion for its 2024 budget, the same figure as for 2023. The House bill would slash the 2025 budget to $10.2 billion, the lowest amount for IRS's annual funding in 20 years. The White House strongly opposes the measure.

DIRECT FILE

The GOP's dislike of IRS's Direct File program is reflected in the funding bill. It explicitly bars the agency from spending any money given to it by Congress to develop or provide taxpayers a free, public electronic return-filing service option, without prior approval of various congressional committees. This past filing season, IRS initiated a pilot for eligible individuals in 12 states with certain types of income and credits who chose to opt in. Filers got a guide and support from IRS workers and could e-file for free. The pilot was a success, and IRS wants to make it permanent and to expand the option to more taxpayers, starting with 2024 returns filed in 2025.

Meanwhile, three more states have signed on to IRS's Direct File program, bringing the number of states to 15 for 2025. Eligible individuals in N.J., Ore. and Pa. will qualify to use the program, along with filers in Ariz., Calif., Fla., Mass., Nev., N.H., N.Y., S.D., Tenn., Texas, Wash. and Wyo. A few more states might come on board before the 2025 filing season...that is, if the GOP efforts to quash Direct File fail.

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SUPREME COURT

Thinking of challenging an IRS regulation as arbitrary and capricious? A Supreme Court decision opens the door to facial challenges of older regs. Facial challenges under the Administrative Procedure Act include the following: IRS didn't give proper notice when proposing the rules or didn't consider all comments before finalizing them. The regs are arbitrary and capricious or exceed IRS's authority.

The six-year period for filing such a suit begins when the plaintiff is injured, not when the final rule is issued, the high court held in a case not involving taxes. The decision came as a surprise to many attorneys (Corner Post v. Federal Reserve).

BUSINESS TAXES

The Tax Court addresses stock sales to an ESOP and the installment method. Shareholders in a corporation can defer tax by selling shares to an ESOP. The gain is postponed by using the sales proceeds to buy replacement securities within a year of the sale. The deferred gain is taxed when the replacement securities are disposed of. Owners must sell 30% or more of the firm to qualify for this break.

Here, "borrowing" against replacement securities killed the ESOP tax deferral. A man sold stock to an ESOP for a promissory note, on which a first payment was made in the next year. He elected to defer his ESOP sale gain by investing the proceeds in floating rate notes. He transferred the notes to a third party, who sold them and purported to lend him 90% of the proceeds on a nonrecourse basis. He agreed with IRS that the scheme was a sale of the notes under the applicable ESOP statute.

However, the stock sale to the ESOP qualifies as an installment sale. An installment sale occurs when at least one payment from the sale of certain property is to be received by the seller after the close of the year in which the sale occurs. The Tax Court in the case agreed with the taxpayer that he never affirmatively elected for the installment method not to apply, and that the applicable ESOP statute doesn't override use of the installment method (Berman, 163 TC No. 1).

TAX DISPUTES

A U.S. entity that doesn't exist under state law can't petition the Tax Court. It lacks the legal capacity to file suit. After IRS issued a notice of deficiency to a company that filed Form 1120, the firm filed a Tax Court petition. IRS claimed that it wasn't a legally existing entity and lacked the capacity to litigate in Tax Court. The company's operating agreement identifies the firm as an LLC organized in Colo. But the taxpayer never filed organization documents in Colo. or in any other state to become a legal entity. The Tax Court tossed the case (Four Square Impex, TC Order).

Innocent spouse relief is available only for unpaid taxes and deficiencies... But not for the Service's recovery of erroneous interest-only payments, the Tax Court decides. IRS issued an erroneous refund consisting of only interest to a couple. When IRS sought to recover the interest, the wife submitted a request for innocent spouse relief, claiming it was inequitable for the Service to go after her for the interest amount. The Court concluded the interest-only erroneous refund didn't give rise to an unpaid tax or deficiency, so the wife is not eligible for innocent spouse relief under the federal tax laws (LaRosa, 163 TC No. 2).

TAX SCAMS

Scammers on social media are touting a nonexistent COVID-19 tax break: The "self-employment tax credit." There is no such credit in the tax code. IRS has issued a consumer alert warning individuals not to fall for these scams, which claim that self-employed people and gig workers can qualify for up to $32,000 in pandemic-relief credits and payments. Per IRS, the credit referred to on these posts was a limited payroll tax break only in 2020 and 2021 for paid sick and family leave. The first COVID-19 stimulus bill gave payroll-tax credits to many small businesses that gave paid leave for workers who couldn't work because they or a family member had COVID. Self-employed individuals also qualified for this limited tax break. The credits offset payroll taxes, including SECA taxes owed by the self-employed.

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TAX FILINGS A key filing deadline for some firms with tax extensions is coming up: 2023 returns of calendar-year partnerships and S corps are due Sept. 16. Late return filers face a stiff fine: $235 for each month late, up to a maximum of 12 months, multiplied by the number of partners or shareholders in the company.

Entities in some federally declared disaster areas have more time to file.

STATE TAXES Md.'s digital advertising tax survives another legal challenge. The tax, which ranges from 2.5% to 10%, hits companies with global gross revenues of $100 million or more that have at least $1 million of gross revenues that are derived from digital advertising services in the state. Opponents have challenged the tax in federal and state courts. Last year, the state's highest court dismissed a case on procedural grounds. Now, a federal district court has ruled in favor of the state in a First Amendment case brought by the U.S. Chamber of Commerce. Meanwhile, more legal cases are pending (Chamber of Commerce v. Lierman, D.C., Md.).

BANKRUPTCY Ill. law doesn't exempt a Canadian retirement plan from bankruptcy creditors, an appeals court says. Ill. bankruptcy law exempts from a bankruptcy estate retirement accounts that are intended in good faith to qualify as a retirement plan under applicable provisions of the U.S. tax code. Here, a man who filed for bankruptcy in Ill. sought to exempt his full balance in a Registered Retirement Savings Plan that was organized under Canadian law. The appeals court rejected his plea because his Canadian plan didn't meet the rules of a qualified retirement plan under any provision of the U.S. federal tax code (Green v. Leibowitz, 7th Cir.).

ENFORCEMENT IRS's efforts at targeting millionaires with big unpaid tax debts are paying off. Last fall, IRS began a compliance program aimed at collecting unpaid taxes from high-income taxpayers. The Service says it has raked in more than $1 billion from 1,200 filers with over $1 million in income and over $250,000 in tax debt. IRS expects to collect even more revenue in the coming months from this crackdown.

If you disagree with an IRS audit determination, think about appealing. IRS's Independent Office of Appeals falls within the Revenue Service, but is separate from the examination and collection divisions. As a general rule, taxpayers can request a conference with Appeals by submitting a written protest or statement setting forth the issues in dispute and the reasons for disagreement. Taxpayers can select conferences to be held by correspondence (either through mail or secure electronic messaging), telephone, video or an in-person meeting.

Cases in Appeals last, on average, six to nine months. They can take longer, depending on the complexity of the issues, legal precedents and other factors. Cases that are on the Tax Court's docket prior to coming to Appeals take more time. If you want to speak with a manager of the Appeals officer handling your case, check the letter you received from Appeals for the manager's contact information.

Appeals has the authority to lower the tax owed in order to settle the dispute. The office weighs the probable outcomes if the case were to end up in court and can offer a settlement. Not all disputes merit a compromise, but many do.

Yours very truly,

Joy Taylor

Aug. 1, 2024 Joy Taylor, Editor

P.S. *Kiplinger Retirement Planning 2024* is packed with retirement advice, and it costs just $11.99 plus shipping. Visit *www.kiplinger.com/go/2024rpg* to order.

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