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Tax Developments in the Second Quarter Of 2014

The following is a summary of the most important tax developments that have occurred in the past three months that may affect you, your family, your investments, and your livelihood. Please call us for more information about any of these developments and what steps you should implement to take advantage of favorable developments and to minimize the impact of those that are unfavorable.

No bankruptcy exemption for inherited IRAs. A unanimous Supreme Court has held that inherited IRAs do not qualify for a bankruptcy exemption, i.e., they are not protected from creditors in bankruptcy. Under the Bankruptcy Code, a debtor may exempt amounts that are both (1) "retirement funds," and (2) exempt from income tax under one of several Internal Revenue Code provisions, including the one that provides a tax exemption for IRAs. Resolving a conflict between the Circuit Courts of Appeal, the Supreme Court has held that this exemption does not extend to inherited IRAs because funds held in them are not retirement funds. For this purpose, the term "inherited IRA" doesn't include amounts inherited by the spouse of the decedent. This decision should be taken into account when selecting IRA beneficiaries. If a potential beneficiary is under financial distress, the IRA owner should consider naming a trust as beneficiary instead. The individual could be named as beneficiary of the trust without jeopardizing the full IRA funds if he or she personally goes bankrupt.

Purchase of underlying property didn't prevent deduction for lease termination payment. The Court of Appeals for the Sixth Circuit has allowed a party that exercised an option to buy property that it was leasing, to deduct a portion of the amount tendered in the transaction as a lease termination payment. In so doing, it rejected the IRS's argument that the full amount tendered had to be capitalized as part of the purchase price. The dispute centered on an obscure tax law. It states that where property is acquired subject to a lease, no basis is allocated to the leasehold interest. The IRS said that this provision precluded a deduction, but the Sixth Circuit disagreed. It held that because the lease terminated when the taxpayer acquired the property, the property was not acquired subject to a lease, and the law at issue did not apply to bar the deduction. Years earlier, the Tax Court reached the opposite result in a case with similar facts.

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Employer health insurance tactic may backfire. The IRS has warned of costly consequences to an employer that doesn't establish a health insurance plan for its employees, but reimburses them for premiums they pay for health insurance (either through a qualified health plan in the Marketplace or outside the Marketplace). According to the IRS, these arrangements, which are called employer payment plans, are considered to be group health plans subject to the market reforms of the Affordable Care Act. These reforms include the prohibition on annual limits for essential health benefits and the requirement to provide certain preventive care without cost sharing. Such arrangements cannot be integrated with individual policies to satisfy the market reforms. Consequently, such an arrangement fails to satisfy the market reforms and may be subject to a $100/day excise tax per applicable employee.

Qualified retirement plans and IRAs may permit purchases of "longevity" annuities. The IRS has issued regulations that allow purchases of deferred "longevity" annuities under various tax-favored retirement vehicles including 401(k) plans and IRAs. Under the regulations, retirees may use a limited portion of their retirement savings to purchase guaranteed income for life starting at an advanced age, such as 80 or 85, to address the risk of outliving their assets.

More enforcement of responsible person penalty likely. If an employer fails to properly pay over its payroll taxes, the IRS can seek to collect a trust fund recovery penalty equal to 100% of the unpaid taxes from a person who is responsible for collecting and paying over payroll taxes and who willfully fails to do so. A recent report issued by the Treasury Inspector General for Tax Administration has found the IRS has often not taken adequate and timely actions in assessing and collecting the responsible person penalty. The report also makes recommendations for improvements. The IRS has agreed to implement the recommendations making greater enforcement of the penalty more likely.

Big tax for sellers who got home back from defaulting buyer. In a recent case, a married couple sold their home at a big gain for installment payments and a balloon payment down the road. In the process, they permissibly excluded $500,000 of their gain under the special exclusion for gain on sale of a principal residence. The buyers ultimately defaulted and the sellers got the home back. The IRS said that they had to report the previously excluded $500,000 gain on the reacquisition. The dispute wound up in the Tax Court, which sided with the IRS.

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More trust/estate expenses escape deduction limit. Miscellaneous itemized deductions are allowed only to the extent they exceed 2% of adjusted gross income (AGI). For this purpose, the AGI of an estate or trust is computed the same way as for an individual, subject to certain exceptions. Under one exception, costs paid or incurred in connection with the administration of an estate or trust that wouldn't have been incurred if the property weren't held in the estate or trust are allowed as deductions in arriving at AGI. For a number of years, the IRS provided guidance on which costs qualified for the exception including proposed regulations issued in 2011. Recently, the IRS has issued final regulations, which list more trust/estate expenses that are deductible in computing an estate or trust's AGI than were included in the earlier guidance.

Next year's inflation adjustments for health savings accounts. The IRS has provided the annual inflation-adjusted contribution, deductible, and out-of-pocket expense limits for 2015 for health savings accounts (HSAs). Eligible individuals may, subject to statutory limits, make deductible contributions to an HSA. Employers as well as other persons (e.g., family members) also may contribute on behalf of an eligible individual. Employer contributions generally are treated as employer-provided coverage for medical expenses under an accident or health plan and are excludable from income. In general, a person is an "eligible individual" if he is covered under a high deductible health plan (HDHP) and is not covered under any other health plan that is not a high deductible plan, unless the other coverage is permitted insurance (e.g., for worker's compensation, a specified disease or illness, or providing a fixed payment for hospitalization). For calendar year 2015, the limitation on deductions is $3,350 (up from $3,300 for 2014) for an individual with self-only coverage. It's $6,650 (up from $6,550 for 2014) for an individual with family coverage under a HDHP. Each of these amounts is increased by $1,000 if the eligible individual is age 55 or older. For calendar year 2015, a "high deductible health plan" is a health plan with an annual deductible that is not less than $1,300 (up from $1,250 for 2014) for self-only coverage or $2,600 (up from $2,500 for 2014) for family coverage, and with respect to which the annual out-of-pocket expenses (deductibles, co-payments, and other amounts, but not premiums) do not exceed $6,450 (up from $6,350 for 2014) for self-only coverage or $12,900 for family coverage (up from $12,700 for 2014).

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Taxpayer Bill of Rights. The IRS recently adopted a "Taxpayer Bill of Rights" to help taxpayers better understand their rights. While taxpayers already had these rights, they were scattered in various provisions of the Internal Revenue Code and were unknown to many taxpayers. They are now prominently displayed on the IRS's web site and fall into these 10 broad categories: (1) the right to be informed; (2) the right to quality service; (3) the right to pay no more than the correct amount of tax; (4) the right to challenge the IRS's position and be heard; (5) the right to appeal an IRS decision in an independent forum; (6) the right to finality; (7) the right to privacy; (8) the right to confidentiality; (9) the right to retain representation; and (10) the right to a fair and just tax system.

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