Current Federal Tax Developments

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Section: 402
Employer Retirement Account Being Paid to Spouse of Employee Cannot be Transferred to Inherited IRA of Spouse's Beneficiary at Spouse's Death

Citation: Information Letter INFO 2017-0030, 12/29/17

A surviving spouse was being paid out of an employer sponsored retirement plan based on an account held by the now deceased spouse. In Information Letter INFO 2017-0030 the IRS addressed the question of whether, now that the surviving spouse had passed away, the balance of the account could be transferred to an inherited IRA for the benefit of a beneficiary of the surviving spouse.

IRC Section 402(c)(11) allows for a rollover of an employer retirement account balance as outlined below:

> *(11) Distributions to inherited individual retirement plan of nonspouse beneficiary*
>
> > *(A) In general*
> >
> > *If, with respect to any portion of a distribution from an eligible retirement plan described in paragraph (8)(B)(iii) of a deceased employee, a direct trustee-to-trustee transfer is made to an individual retirement plan described in clause (i) or (ii) of paragraph (8)(B) established for the purposes of receiving the distribution on behalf of an individual who is a designated beneficiary (as defined by section 401(a)(9)(E)) of the employee and who is not the surviving spouse of the employee—*
> >
> > > *(i) the transfer shall be treated as an eligible rollover distribution,*
> > >
> > > *(ii) the individual retirement plan shall be treated as an inherited individual retirement account or individual retirement annuity (within the meaning of section 408(d)(3)(C)) for purposes of this title, and*
> > >
> > > *(iii) section 401(a)(9)(B) (other than clause (iv) thereof) shall apply to such plan.*

A "designated beneficiary" of the employee is defined at IRC §401(a)(9)(E) as:

> *(E)Designated beneficiary.—*
>
> *For purposes of this paragraph, the term "designated beneficiary" means any individual designated as a beneficiary by the employee.*

The problem in this case is that the person who wishes to have a balance transferred to the IRA was not designated by the employee, but rather by the employee's surviving spouse. As the letter notes:

> *Accordingly, Section 402(c)(11) does not apply to a beneficiary of a surviving spouse or other designated beneficiary. Thus, a transfer to an inherited IRA for the benefit of a beneficiary of the surviving spouse would not be an eligible rollover distribution because the beneficiary is not a designated beneficiary of the deceased employee.*

The key problem with this situation is that the surviving spouse continued to receive the benefit from the plan as a beneficiary of the deceased employee. Had the funds been rolled to an IRA,

IRC §402(a)(9) would have allowed the spouse to treat the distribution as his/her own, creating the spouse's own IRA.

In that case, the spouse's beneficiary would then have received an inherited IRA, and that IRA could have been transferred in a trustee to trustee transfer to another custodian who would hold it as an inherited IRA.

Section: 408
Taxpayer Who Rolled After-Tax Contributions to Traditional IRA Has Basis in the IRA

Citation: Information Letter INFO 2017-0028, 12/29/17

He who hesitates is lost the saying goes, and in taxes that is often very true when facing statute of limitations to fix a problem. But in Information Letter INFO 2017-0028 the IRS "solved" the taxpayer's problem from 2006, largely by pointing it there really wasn't the problem the taxpayer thought existed.

While we don't know for sure why the taxpayer decided to look back at his actions in 2006 at this late date, he did so and contacted his Congressman who contacted the IRS. The taxpayer in 2006 had rolled 401(k) funds from his employer's plan to a traditional IRA. However, the 401(k) included after-tax contributions and the taxpayer indicated he had "inadvertently" rolled those funds into a traditional IRA rather than a Roth IRA. The taxpayer was asking how he could get credit for the taxes he had paid on those funds.

The IRS pointed out first that, in 2006, taxpayers could not roll amounts from employer-sponsored retirement plans to a Roth IRA. The Pension Protection Act of 2006 did add a provision to the law that authorized such rollovers, but it was effective only for rollovers made *after* 2007.

However, the IRS pointed out all is not lost. The taxpayer merely needs to complete Form 8606, *Nondeductible IRAs*, when he takes a distribution from the plan. That form will give him credit for the basis he has in the account due to rolling over pre-tax contributions from the IRA, pointing out that "any after-tax monies would be excluded as they came out of the receiving plan or IRA."

As the letter goes on to explain:

> *If an individual's traditional IRAs, when combined, contain both pre-tax and after-tax monies, the rules treat any distribution as consisting of a proportionate share of each. An individual must report such a distribution on Form 8606, Nondeductible IRAs. The instructions for line 2 of the form explain that any nontaxable portion of a rollover from a qualified retirement plan is reported on line 2. By reporting them on line 2 of the form, an individual gets credit for after-tax monies rolled into the IRA (even if the rollover was made in an earlier tax year).*

Section: 6015
Despite Finding Taxpayer Had Constructive Knowledge of Income, Innocent Spouse Relief Under Section 6015(c) Granted

Citation: Bishop v. Commissioner, TC Summary Opinion 2018-1, 1/4/18

A taxpayer was granted innocent spouse relief in the case of *Bishop v. Commissioner,* TC Summary Opinion 2018-1, despite the fact that the Tax Court found that he should have been aware of the distribution that gave rise to the liability.

The taxpayer's spouse had inherited an IRA account from her father in 2009. From 2009 to 2013 various distributions had been taken from the account, ranging from $4,000 to $48,000, and reported on the couple's joint income tax return.

In 2014 the spouse took a distribution from the inherited IRA of $15,068. The custodian withheld $2,712 for federal taxes, $6,000 was deposited into the couple's joint checking account with the remainder being used for the benefit of the spouse's daughter.

The couple filed a joint return for 2014. The couple provided information to a paid preparer to prepare the 2014 return, but the IRA distribution did not end up being reported on that return. In 2015 the couple separated and they were divorced in 2016.

The IRS issued a notice regarding the 2014 distribution based on the 1099 received from the custodian. The taxpayer filed a Form 8857, *Request for Innocent Spouse Relief*, with the IRS.

Innocent spouse relief is governed by a set of provisions in IRC §6015 that provide several circumstances under which relief can be granted to a requesting spouse. The IRS first analyzed the taxpayer's request by looking at IRC §6015(b). That provides:

> *(b) Procedures for relief from liability applicable to all joint filers*
>
> *(1) In general*
>
> *Under procedures prescribed by the Secretary, if—*
>
> > *(A) a joint return has been made for a taxable year;*
> >
> > *(B) on such return there is an understatement of tax attributable to erroneous items of one individual filing the joint return;*
> >
> > *(C) the other individual filing the joint return establishes that in signing the return he or she did not know, and had no reason to know, that there was such understatement;*
> >
> > *(D) taking into account all the facts and circumstances, it is inequitable to hold the other individual liable for the deficiency in tax for such taxable year attributable to such understatement; and*
> >
> > *(E) the other individual elects (in such form as the Secretary may prescribe) the benefits of this subsection not later than the date which is 2 years after the date the Secretary has begun collection activities with respect to the individual making the election,*
>
> *then the other individual shall be relieved of liability for tax (including interest, penalties, and other amounts) for such taxable year to the extent such liability is attributable to such understatement.*

In this situation the IRS found that the taxpayer should have known about the deposit into the joint checking account. The Tax Court, agreeing with this conclusion of the IRS, noted:

> *The history of withdrawals from the retirement account used by the parties over a period of years and the transactions by petitioner with reference to the joint bank account support a conclusion that petitioner should have known about the distribution. The amount was very large in relation to the average balances and other transactions in the account.*

But that is not the provision under which relief can be granted. The taxpayer, having separated from his spouse and then gone through with a divorce, also potentially qualified for relief under IRC §6015(c). That provision provides:

> *(c) Procedures to limit liability for taxpayers no longer married or taxpayers legally separated or not living together*
>
> > *(1) In general*
> >
> > *Except as provided in this subsection, if an individual who has made a joint return for any taxable year elects the application of this subsection, the individual's liability for any deficiency which is assessed with respect to the return shall not exceed the portion of such deficiency properly allocable to the individual under subsection (d).*
> >
> > *(2) Burden of proof*
> >
> > *Except as provided in subparagraph (A)(ii) or (C) of paragraph (3), each individual who elects the application of this subsection shall have the burden of proof with respect to establishing the portion of any deficiency allocable to such individual.*
> >
> > *(3) Election*
> >
> > > *(A) Individuals eligible to make election*
> > >
> > > > *(i) In generalAn individual shall only be eligible to elect the application of this subsection if—*
> > > >
> > > > > *(I) at the time such election is filed, such individual is no longer married to, or is legally separated from, the individual with whom such individual filed the joint return to which the election relates; or*
> > > > >
> > > > > *(II) such individual was not a member of the same household as the individual with whom such joint return was filed at any time during the 12-month period ending on the date such election is filed.*
> > > >
> > > > *(ii) Certain taxpayers ineligible to elect*
> > > >
> > > > *If the Secretary demonstrates that assets were transferred between individuals filing a joint return as part of a fraudulent scheme by such individuals, an election under this subsection by either individual shall be invalid (and section 6013(d)(3) shall apply to the joint return).*

> *(B) Time for election*
>
> *An election under this subsection for any taxable year may be made at any time after a deficiency for such year is asserted but not later than 2 years after the date on which the Secretary has begun collection activities with respect to the individual making the election.*
>
> *(C) Election not valid with respect to certain deficiencies*
>
> *If the Secretary demonstrates that an individual making an election under this subsection had actual knowledge, at the time such individual signed the return, of any item giving rise to a deficiency (or portion thereof) which is not allocable to such individual under subsection (d), such election shall not apply to such deficiency (or portion). This subparagraph shall not apply where the individual with actual knowledge establishes that such individual signed the return under duress.*

A key difference in this case is the test for knowledge of the understatement. Unlike §6015(b) where the fact the taxpayer *should have known* of the income is fatal to a grant of relief, IRC §6015(c)(3)(C) only denies relief if there was *actual knowledge* of the income by the requesting spouse—that is, in this case ignorance is truly bliss.

The IRS found that there was no evidence that the taxpayer was aware of the distribution despite the fact he should have been. Obviously, the taxpayer's ex-spouse wasn't happy with that decision, as now she would be liable for the entire deficiency personally with her ex-husband off the hook. So, she intervened and took the matter to Tax Court.

The Tax Court first notes that the traditional methods for determining burden of proof in Tax Court proceedings don't work here—the real dispute is not between the IRS and the taxpayers, but between the taxpayers themselves. So the Court noted:

> *A question exists as to where the burden of proof lies in cases when, as here, the IRS favors granting relief and the nonrequesting spouse intervenes to oppose it. The Court has resolved such cases by determining whether actual knowledge has been established by a preponderance of the evidence as presented by all parties. See Pounds v. Commissioner, T.C. Memo. 2011-202; Knight v. Commissioner, T.C. Memo. 2010-242; McDaniel v. Commissioner, T.C. Memo. 2009-137; Stergios v. Commissioner, T.C. Memo. 2009-15.*

The Court then looks at the ex-wife's arguments and evidence, since she is the one asserting that her ex-husband had actual knowledge of the distribution. The Court notes:

> *Intervenor disputes petitioner's credibility. She argues that he had actual knowledge of the 2014 distribution because it was deposited in their joint bank account about seven months before the return was prepared and petitioner continued to write checks from the account and use debit cards accessing funds in the account. Intervenor does not claim that she specifically told petitioner about the distribution when it was received or at the time that the return was prepared or point to any evidence that petitioner had "an actual and clear awareness (as opposed to reason to know)" of the items giving rise to the deficiency. Intervenor testified that they both forgot about the distribution at the time the return was prepared.*

The inability of the ex-wife to point to actual knowledge of the distribution was fatal to her attempt to get the IRS decision to grant relief overturned. As the Court concluded:

> *There is no evidence, however, that petitioner saw the bank records before the joint return for 2014 was filed. His denials are not incredible, implausible or contradicted by direct evidence. See Culver v. Commissioner, 116 T.C. 189; Richard v. Commissioner, T.C. Memo. 2011-144. Regardless of the strong indications of constructive knowledge, the evidence falls short of establishing actual knowledge of any specific amount of the distribution in 2014.*

Section: 6501
Six Year Statute on Failure to Report Income from Foreign Assets Does Not Apply to Years Before Asset Information Reporting Required

Citation: Rafizadeh v. Commissioner, 150 TC No. 1, 1/2/18

The first published Tax Court decision of 2018 deals with an issue that likely won't impact a whole lot of taxpayers, but does give a look at how the court interpret a statute. The case of *Rafizadeh v. Commissioner*, 150 TC No. 1 looks at how the expansion of the statute of limitations for cases involving a failure to report income from foreign financial assets applies to years before the information reporting for those assets applied.

Under IRC §6501(e)(1)(A)(ii) the statute of limitations for the IRS to assess tax is expanded to six years from three years if the understatement:

> *(I) is attributable to one or more assets with respect to which information is required to be reported under section 6038D (or would be so required if such section were applied without regard to the dollar threshold specified in subsection (a) thereof and without regard to any exceptions provided pursuant to subsection (h)(1) thereof), and*
>
> *(II) is in excess of $5,000…*

There was no question that the taxpayer in this case had failed to report income from foreign accounts in the years in question and that the failure had created a tax understatement of more than $5,000. But since the above provision and IRC §6038D that it references were enacted as part of the Hiring Incentives To Restore Employment Act of 2010 (HIRE Act) in 2010, did it apply to extend the statute for 2006-2009, the years the IRS was attempting to collect tax from.

You might think the question is whether Congress would have the power to retroactively change the statute, but that's not really an issue. Congress has often extended statutes to apply in any case where a statute had not already expired by the effective date of the law.

Here the taxpayer argued that the wording of the law meant it could only apply to years where there was a reporting requirement under IRC §6038D. As the Court notes:

> *Specifically petitioner argues that the defining phrase in section 6501(e)(1)(A)(ii) ("assets with respect to which information is required to be reported under section 6038D") also limits application of the six-year limitations statute to assets for which there was a reporting requirement under section 6038D (or there would be a requirement but for specified exceptions) at the time the income was omitted.*

That is, the underreporting did not relate to an asset required to be reported under IRC §6038D since, for 2006-2009, there was no such information reporting requirement.

The Court found that reading the law as the taxpayer suggested was the most reasonable interpretation. As the Court noted:

> *While the effective date of section 6038D was not imported by the cross-reference to section 6038D, we conclude that the most natural reading of this phrase is that the six-year statute of limitations applies only when there is a section 6038D reporting requirement (or would be barring an exception that is to be disregarded). Section 6501(e)(1)(A)(ii) does not simply incorporate the definition of assets in section 6038D; it also specifies that the assets are subject to the reporting requirement (or would be but for an exception that is disregarded). We agree with petitioner that had Congress intended simply to incorporate the definition in section 6038D of the assets to be covered, Congress could have used other more straightforward wording, such as the defined term itself. Cf. Leslie v. Commissioner, 146 F.3d 643, 650-651 (9th Cir. 1998) (limiting cross-reference in section 6621(c)(3)(A)(iii) to "any straddle (as defined in section 1092 * * *)" to the definition of straddle in section 1092, and declining to import the effective date of section 1092 as well), aff'g T.C. Memo. 1996-86.*