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Tax News and Industry Updates

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Inside This Issue

Partial IRA Rollover Allowed

Cross References

- *Haury,* U.S. Court of Appeals, 8th Cir., May 12, 2014

A taxpayer withdrew amounts from his IRA to help fund product development and working capital needs for his business. He also made a partial rollover contribution back into his IRA as a result of funds received from his business for the repayment of loans. The following transaction dates, withdrawal amounts, and rollover contributions illustrate the IRA account transaction history for the tax year at issue:

Transaction Date	*Withdrawals*	*Contributions*
February 15, 2007	$120,000.00	
April 9, 2007	$168,000.00	
April 30, 2007		$120,000.00
May 14, 2007	$100,000.00	
July 6, 2007	$46,933.06	
October 25, 2007	$31.32	
Totals	$434,964.38	$120,000.00

Seizing on the fact that the $120,000 contribution on April 30 matched the $120,000 February 15 withdrawal, the IRS argued that it was not a qualifying rollover contribution because it was not made within the 60-day time limit. The taxpayer, representing himself during the Tax Court trial, never raised the issue that the $120,000 contribution on April 30 could qualify as a partial IRA rollover for the April 9 withdrawal. The Tax Court agreed with the IRS and included the $120,000 in determining the amount of the taxpayer's taxable income from IRA distributions that year.

On appeal, the taxpayer was represented by counsel. The taxpayer argued that the $120,000 IRA contribution on April 30 was a qualifying partial rollover of the $168,000 IRA distribution made on April 9 because it was less than 60 days before the contribution. The IRS acknowledged to the Appeals Court that the 60-day limit under IRC section 408(d)(3)(A)(i) was satisfied. The IRS nonetheless argued two defenses to this contention:

- The partial rollover issue was forfeited because the taxpayer failed to argue it to the Tax Court.
- The taxpayer failed to prove that he had not made a prior rollover contribution within one year of April 30, 2007.

The Court of Appeals said it was appalled by the unfairness of this contention. At trial, the taxpayer simply explained the facts, as the presiding Tax Court judge directed him to do. It was the IRS attorneys who matched up the two $120,000 transactions and, ignoring the obviously applicable partial rollover provision, asserted that the rollover contribution was untimely. The issue before the Tax Court was whether this was a qualifying rollover contribution. The Tax Court was obligated to fairly apply the statue to the facts presented, particularly for a taxpayer representing himself before the court.

The Court of Appeals also said the second IRS contention was without merit, if not downright silly. As IRS counsel conceded at oral argument, the IRS had access to the transactions in the taxpayer's IRA account during the year prior to April 30, 2007. Had there been a prior rollover contribution, it would have been a complete defense to the taxpayer's rollover contention, because the one-year limitation applies to all rollover contributions claims, whether complete or partial. Had the IRS' exhaustive review of the transactions in the taxpayer's IRA account revealed a disqualifying prior rollover contribution during the prior year, the IRS would have asserted this defense before the Tax Court, making the 60-day limit the IRS in fact asserted unnecessary. As the IRS did not raise the one-year issue, the taxpayer had no need to address it at trial.

The Court of Appeals reversed the Tax Court decision and allowed the $120,000 partial IRA rollover contribution.

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IRS Direct Pay

Cross References

• www.irs.gov

The IRS has launched a new way for taxpayers to pay their tax liability online. The IRS Direct Pay website allows taxpayers to pay their Form 1040 tax bill or make estimated tax payments directly from their checking or savings account at no cost. The taxpayer receives instant confirmation that a tax payment has been submitted. Bank account information is not retained in the IRS systems after payments are made.

The taxpayer must have a valid Social Security Number to use the application. The application cannot accommodate Individual Taxpayer Identification Numbers (ITINs).

Paying taxes online is done in five steps:
• Provide tax information.
• Verify the taxpayer's identity.
• Enter payment information.
• Review and electronically sign the transaction.
• Print or record the online confirmation number.

Prior year tax returns. The system allows for payments towards a 1040 tax return for the last 20 years. There are two exceptions—estimated tax payments and payments with requests for extension of time to file can be made for the current tax year only.

Tax payments for returns other than Form 1040. At the current time, only 1040 return series payments can be made through IRS Direct Pay. Additional payment types will likely be added to the application in a future release.

Verifying identity. A taxpayer's identity is verified by using one of the taxpayer's prior year processed tax returns. The taxpayer can choose one of the last five years for identity verification. Information from that return is entered by the taxpayer during step two and the program cross checks that information with the information on the previously filed tax return. If the information matches, the identity is verified. This verifying step must be done each time the taxpayer uses the system to make a payment.

Payment processing. Once a confirmation number is received, the taxpayer should expect it to take two business days to process the payment. Payments submitted after 8 p.m. Eastern time are processed the next business day.

Taxpayers can also schedule a payment for up to 30 business days in advance. At present, there is no provision to set up recurring payments using IRS Direct Pay. Taxpayers making installment agreements should consider using the Online Payment Agreement application. See www.irs.gov/Individuals/Online-Payment-Agreement-Application for details.

If there are insufficient funds in the account at the time the payment is processed, the taxpayer will receive a payment return notice in the mail notifying the taxpayer to resubmit the payment.

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New Email Scam

Cross References

• www.irs.gov

Update your IRS e-file. The IRS has been alerted to a new email phishing scam. The emails appear to be from the IRS and include a link to a bogus website intended to mirror the official IRS web site. These emails contain the direction "you are to update your IRS e-file immediately." The emails mention USA.gov and IRSgov, though notably, not IRS.gov (IRS-dot-gov). These emails are not coming from the IRS.

Taxpayers who get these messages should not respond to the email or click on the links. Instead, they should forward the scam emails to the IRS at phishing@irs.gov. For more information, visit the IRS' Report Phishing web page at www.irs.gov/uac/Report-Phishing.

Important reminder. The IRS does not initiate contact with taxpayers by email, texting, or any social media.

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HSA Inflation Adjusted Amounts

Cross References

- IRC §223
- Rev. Proc. 2014-30
- Rev. Proc. 2013-25
- Rev. Proc. 2012-26

The IRS announced inflation adjusted amounts for Health Savings Accounts (HSAs) for 2015. These amounts are reflected in the chart below.

HSA Limitations

Annual contribution is limited to:	2015	2014	2013
Self-only coverage, under age 55	$3,350	$3,300	$3,250
Self-only coverage, age 55 or older	$4,350	$4,300	$4,250
Family coverage, under age 55	$6,650	$6,550	$6,450
*Family coverage, age 55 or older	$7,650	$7,550	$7,450
Minimum annual deductibles:			
Self-only coverage	$1,300	$1,250	$1,250
Family coverage	$2,600	$2,500	$2,500
Maximum annual deductible and out-of-pocket expense limits:			
Self-only coverage	$6,450	$6,350	$6,250
Family coverage	$12,900	$12,700	$12,500

* Assumes only one spouse has an HSA. See IRS Pub. 969 if both spouses have separate HSAs.

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Insider Trading Restitution Payments Deductible as a Loss

Cross References

- *Nacchio,* U.S. Court of Federal Claims, March 12, 2014

From 1997 to 2001, the taxpayer was the Chief Executive Officer (CEO) of Qwest Communications International, Inc. A large portion of his compensation as CEO was in the form of stock options. In 2001, the taxpayer exercised his options and sold 1,255,000 shares of Qwest stock. He reported $44,632,464.38 in net gain and paid $17,974,832 in taxes on this gain.

In 2005, the Securities and Exchange Commission (SEC) initiated a civil action alleging that the taxpayer orchestrated a scheme to defraud the investing public by misrepresenting Qwest's performance and growth in 2001. The SEC claimed the taxpayer earned approximately $176.5 million selling Qwest stock while in possession of insider information.

In 2007, the taxpayer was convicted by a jury of insider trading relating to stock he sold in 2001. The District Court sentenced the taxpayer to 70 months in prison, a $19 million fine, and a $44,632,464.38 forfeiture of net gain from the sale.

The taxpayer then amended his 2007 tax return claiming a $17,999,090 tax credit under IRC section 1341. The IRS disallowed the credit, stating that IRC section 1341 can be invoked only after a valid deduction is claimed under another IRC section. The IRS also said the forfeiture was a penalty for violating the law.

IRC section 1341 applies when a taxpayer repays money in a current year that belongs to someone else, but was money that the taxpayer received and included in gross income in a prior year. The taxpayer must have subjectively believed he had an unrestricted right to the money in the year it was received based on all the facts available in that year. The taxpayer must be entitled to a deduction in excess of $3,000 under another section of the Internal Revenue Code for the loss resulting from repaying the money. If the taxpayer meets the requirements of IRC section 1341, then the taxpayer is entitled to either the equivalent of a refund for income tax paid in the earlier year, or a deduction from income in the year of repayment, whichever is more beneficial to the taxpayer.

The IRS argued the taxpayer did not qualify for IRC section 1341 relief because both public policy considerations and IRC section 162(f) preclude the deduction. In addition, the IRS claimed that because the taxpayer was convicted for acting willfully, knowingly, and with the intent to defraud, the taxpayer cannot prove he believed he had a claim of right to the forfeited funds. The IRS argued that allowing the taxpayer to deduct the forfeited amount would frustrate the policy in the federal criminal code prohibiting deception, misrepresentation, and fraud in connection with the purchase or sale of any security, and as a result, diminish the taxpayer's punishment.

The court said in presenting this argument, the IRS aims to tax the taxpayer on income he did not realize as a form of punishment. However, the Supreme Court has ruled that the federal income tax is a tax on net income, not a sanction against wrongdoing, a principle that has been firmly imbedded in the tax statute from the beginning. In 1913 when Congress first enacted the income tax, the Congressional Record said: “The object of the income tax bill is to tax a man’s net income; that is to say, what he has at the end of the year after deducting from his receipts his expenditures or losses. It is not to reform men’s moral characters; that is not the object of the bill at all.”

The court said the taxpayer’s forfeiture is a loss. The proceeds from the taxpayer’s insider trading evaporated. Yet the IRS seeks to tax these proceeds not on the ground that they are income, but on the notion that the public policy against securities fraud must prevent the deductibility of monies that were received due to insider trading even though the monies were disgorged. However, the taxpayer’s punishment in this case was stern, including a 70-month jail sentence, a $19 million fine, as well as a forfeiture of his gain. The deduction for the forfeiture would not increase the odds in favor of insider trading or destroy the effectiveness of the securities laws. His conviction and punishment is ample weapons to combat insider trading without adding taxation of un-retained income. Disallowing the deduction would result in a double sting by requiring the taxpayer to both make restitution and pay taxes on income he did not retain.

The IRS also tried to argue that IRC section 162(f) prohibits the taxpayer from claiming a loss deduction. IRC section 162(f) says no deduction is allowed for any fine or similar penalty paid to a government for the violation of any law. The IRS argued that IRC section 162(f) can be extended to apply to IRC section 165, which is the code section that allows for a taxpayer to deduct a loss of property. The IRS claimed the forfeiture was in essence a fine or similar penalty imposed to punish the taxpayer for violating the law.

The court said the taxpayer’s $44 million forfeiture was to compensate 112,210 victims of his insider trading. Thus, the forfeiture was used for a compensatory purpose and was not a “similar penalty” under IRC section 162(f). Thus, the court ruled IRC section 162(f) did not apply to the forfeiture.

The IRS also tried to argue that IRC section 1341 did not apply because a jury convicted the taxpayer of engaging in insider trading willfully, and thus the taxpayer knew at the time that he did not have a right to the forfeited funds.

The court said this is a subjective standard that hinges on the taxpayer’s belief during the year of inclusion. The issue presented by IRC section 1341 is not simply whether the taxpayer obtained funds unlawfully, but whether it appeared to him that he had an unrestricted right to those funds. The precise issue of whether the taxpayer himself subjectively belied he had an unrestricted right to the funds he received from trading in 2001 was not adjudicated in the criminal proceedings. The taxpayer did not plead guilty to insider trading. The taxpayer professed his innocence, and nothing in the criminal proceedings sheds any light on the bona fide beliefs of the taxpayer. So the taxpayer’s subjective belief as to his entitlement to the trading gains in 2001 is a question of material fact that cannot be determined by this court. The court ruled in favor of the taxpayer.