Proposed modifications issued for Circular 230

TAX: Here’s a preliminary outline of the major features that are proposed to be incorporated into Circular 230.

By Jennifer MacMillan, EA
Guest Contributor

Now that all tax preparers are solidly entrenched in Circular 230, the IRS has released modifications to the massive overhaul it accomplished in 2011.

In September 2012, long-awaited proposed regulations were issued, bringing clarifications and some welcomed simplification to numerous parts of Circular 230. While these regulations will not likely be made final until early 2013, they lack the controversy of the last round of revisions and, hence, are likely to remain substantially unchanged in the final regulations.

NOTE: The current version of Circular 230 remains in effect until the Final Regulations are issued, so the cautious tax professional might wish to continue using the “disclaimer” until the revisions become law (likely in early 2013).

See Circular 230, page 2

Forms 56, 4506, 4810, 5495: A good night’s sleep

ESTATES AND TRUSTS: Cutting the statute of limitations allows beneficiaries to receive their inheritance as soon as possible.

By Richard B. Malamud, CPA, J.D., LL.M.
Guest Contributor

Beneficiaries of an estate want to receive their inheritance as soon as possible. Normally, distributions are delayed so that final income and estate tax returns can be filed and all known (and any yet to be determined) federal income taxes paid.

Unfortunately, executors or trustees may delay distributions because they may be held liable if these debts are not paid and the IRS can’t collect from the beneficiaries. “A representative of a person or an estate … paying any part of a debt of the person or estate before paying a claim of the Government is liable to the extent of the payment for unpaid claims of the Government.”

Making sure all debts have been paid prior to making final distributions can take years, especially with a taxable estate with valuation issues.

Professional executors, trustees, and even family members who are not sole beneficiaries have ways to protect themselves from personal liability if they are unwilling to trust that the beneficiaries will not squander their inheritance in case the IRS comes calling.

This article will discuss what steps a fiduciary can take to accelerate the distributions while also limiting their personal liability for federal taxes. This article will not cover other possible fiduciary liability issues, such as state taxes or creditor’s claims, which depend on state law.

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Another noteworthy change is the proposed §10.82, which affords the IRS Office of Professional Responsibility (OPR) the ability to utilize expedited sanctions for practitioners who are out of filing compliance with their own tax obligations. In essence, practitioners who have not filed income tax returns in four of the prior five tax years (or five of the prior seven quarterly payroll periods) would fall under these rules. While this affects only a small percentage of tax professionals, the implications for OPR are increased efficiency and swift removal of bad-actors who erode the system and consequently harm taxpayers (as well as other tax professionals, their competitors).

As of this writing, the comment period remains open and hearings are scheduled for December 7, 2012, so objections to these rules as proposed will become evident in the coming weeks. Of course, Spidell Publishing is your best resource for the latest updates on all of your ethical and regulatory requirements, so stay tuned.

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One alternative is to wait until the three-year statute of limitations has run on all tax returns.2 In the case of a decedent dying on January 1, 2013, if the estate tax return is extended six months, the statute of limitations would run until about April 1, 2017 (assuming that all other federal returns have been filed). To speed up the process and avoid personal liability, the fiduciary can:

- File a request with the IRS for a shorter statute of limitations;
- File a request with the IRS for a discharge of the fiduciary personal liability; or
- File a request for both.

The downside to filing either request is that the IRS is likely to audit the income, estate, and gift tax returns. This can be both time consuming and expensive. It could also mean that the IRS will assess additional taxes, which might not have occurred had the estate simply waited for the statute of limitations to run.

Preliminary tasks

To begin the process, gather prior tax returns and inform the IRS that you are the fiduciary:

- Obtain prior tax returns: If it is unclear whether all prior tax returns have been filed, the fiduciary can file Form 4506, Request for Copy of Tax Returns. The request can generally be for up to seven years from filing. A separate one must be filed for each type of return. Doing so may raise ethical issues for the fiduciary if it is discovered that prior gift tax returns were not filed; and
- Make sure the IRS informs the fiduciary of any assessments for prior years: The fiduciary should file Form 56, Notice Concerning Fiduciary Relationship, which informs the IRS of the identity of the fiduciary and directs the IRS to send correspondence to him or her.3 It applies to income, gift, estate, generation skipping transfer, and employment taxes. The fiduciary is then treated as if he or she were the actual taxpayer. If the fiduciary resigns or is replaced, he or she should inform the IRS of that change by filing another Form 56.

Shorten the statute of limitations

Rather than wait for years for the statute of limitations to run on the decedent’s tax returns, Form 4810, Request for Prompt Assessment Under Internal Revenue Code Section 6501(d), can be filed for income, gift, employment, and excise tax returns to shorten the statute of limitations to 18 months from the date of the filing of the form.4 It is filed with the same IRS Service Center where the returns were filed. Filing Form 4810 might cause the IRS to audit a return that otherwise might not have been audited. If the fiduciary is also the sole beneficiary, or if he or she is a beneficiary and there are issues better left to the audit lottery and it is believed that the beneficiaries will not squander their inheritance (so that they can pay any future assessments), then this might not be the best course of action.

It appears that a letter must be used to request an expedited determination of the estate tax due. The IRS only has six months in the case of an estate tax return.

About the author

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Footnotes:
1 REG-138367-06 (September 17, 2012) Federal Register Vol. 77, No. 180
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Fiduciary’s liability

Fiduciaries can be held liable if there were distributions and the taxes were not paid. A fiduciary can apply on Form 5495, Request for Discharge From Personal Liability Under Internal Revenue Code Section 2204 or 6905, for release from personal liability for income, gift, and estate tax. (It does not appear that this applies to fiduciary tax returns.)

Once filed, the IRS has nine months to disclose any amounts owed. If that amount is paid, or if no notification from the IRS is received, the fiduciary is relieved of liability. This will not relieve the beneficiaries of liability to the extent they receive funds from the estate if it is determined that there are unpaid taxes.

Should the estate file these requests?

If the estate is well below the filing requirements and the prior income tax returns are squeaky clean, fiduciary liability may not be a problem worth protecting against. When the fiduciary and siblings are the beneficiaries and there is confidence that they will have sufficient assets and mutual trust should the IRS come calling, it may be worth it to make early distributions, but keep a reserve for three years just in case.

Where the estate has real estate, art, or other property that requires valuation, it is a tough call. On one hand, the distributions can be accelerated by requesting the IRS shorten the statute of limitations, but it is also more likely the estate tax will be increased due to disagreements with the IRS over valuation.

Conclusion

Fiduciaries can be held personally liable if they make distributions to beneficiaries and later there is an IRS deficiency that the heirs don’t pay.

Rather than wait three years for the statute of limitations to run before making distributions, an executor or trustee can request a prompt determination of the taxes owed and a release from personal liability for the fiduciary. These two requests can significantly reduce the time required to make final estate distributions, but they may increase both the professional fees and the taxes owed by the estate.

How an IRA could become a taxable asset

TAX: Two recent bankruptcy court cases show how IRA funds can become includable in a bankruptcy estate.

By Kathryn Zdan, EA
Managing Editor

Retirement funds that are exempt from income tax are also protected assets in bankruptcy proceedings.1 However, if evidence is presented demonstrating that the retirement account was improperly operated or otherwise no longer qualifies for an income tax exemption, the funds will be included in the bankruptcy estate.

Profit-sharing plan loses exempt status

A taxpayer who withheld information about assets during bankruptcy proceedings was denied discharge of debt once the assets were discovered.2 Additionally, past prohibited transactions had caused those assets to lose their tax- and bankruptcy-exempt status.

In this case, the taxpayer had set up a profit-sharing plan, which would have been tax exempt except that he had entered into a series of prohibited transactions:

- Investing personal funds and funds from the profit-sharing plan into a business venture;
- Loaning funds from the profit-sharing plan to his son;
- Engaging the profit-sharing plan in transactions with the daughter of an associate who provided services for the plan;
- Depositing money from the estate of his late uncle into the plan and then using the funds for personal needs;
- Using the plan funds to pay real estate taxes on properties held by the taxpayer’s trust; and
- Depositing into the plan rent checks for properties held by the taxpayer’s trust.

When the taxpayer filed for bankruptcy, these funds were no longer excludable from the bankruptcy estate. Just before declaring bankruptcy, the taxpayer moved almost $500,000 out of the profit-sharing plan and into two IRAs — the existence of which he did not disclose during the bankruptcy proceeding. When the bankruptcy court discovered the existence of the IRAs, which were accidentally revealed by the taxpayer’s counsel, the court revoked the discharge of debt through the bankruptcy for concealment of assets. A district court affirmed. The IRAs would not have protected the funds from tax if they had remained undiscovered because they were funded by the nonexempt profit-sharing plan. Even if the IRAs had been created using exempt funds, the fact that they had been concealed would have still disqualified them from being exempted from the bankruptcy.

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1 31 USC §3713(b)
2 See generally IRS Publication 559, Survivors, Executors, and Administrators
3 IRC §6903; Treas. Regs. §301.6903-1
4 This will not shorten the statute of limitations on a joint return for the surviving spouse. See Rev. Rul. 72-338