Dear Client:

Note this growing trend in state taxation:
Hitting more online purchases with sales tax.
Sales of goods through the Internet have grown
by leaps and bounds and will continue to increase.
But states haven't been able to fully reap the revenues
from sales tax collection on purchases by their residents
from electronic retailers who are located out of state.

Much of e-commerce isn't now subject to tax.
A Supreme Court decision shields out-of-state sellers
with no physical presence in the buyer's home state
from having to collect sales tax. Collection is required
of retailers with a physical presence, such as a store, factory or warehouse.
In the era of online buying, states are taking the lead in wanting the rules changed.
States can levy use tax on their residents for purchases if sales tax isn't paid.
But compliance is dismal. Most people aren't even aware of the use tax rules,
and many who know of the requirement still don't always comply with their obligation.
States have been hoping for years that Congress would act on this issue.
But lawmakers' efforts have stalled. In 2013, the Senate passed a bill
to require firms with Web sales of over $1 million to collect sales taxes from buyers
who live in states with sales taxes. Rep. Jason Chaffetz (R-UT) has a similar proposal,
albeit with some changes from the Senate bill. Neither of these is on the fast track.

Tired of waiting, states are enacting their own Internet sales tax laws.
Take South Dakota. Its law directly conflicts with the Supreme Court ruling.
Sellers who have no physical presence in S.D. and make over $100,000 in yearly sales
or 200 transactions in the state are required to collect sales tax from S.D. buyers.
It just took effect, and a lawsuit has already been filed claiming it's unconstitutional.
Many believe that this case could ultimately make its way up to the Supreme Court,
and states are hoping the high court will overturn or narrow its decades-old decision.
Ala. is another example. Out-of-state sellers must collect Ala. sales tax
if their annual in-state sales exceed $250,000. A legal challenge was recently filed.
More states are expected to follow suit, including Mass., Utah and Vt.

A number of states have taken a less drastic approach, akin to that of N.Y.
Online sellers must collect N.Y. sales tax if they pay websites operated by N.Y. residents
for referral business. Clicking through Web links can establish the required nexus.
The law has been challenged in court and ruled to be valid. La. now follows this model.
Beginning this past April, out-of-state retailers are required to collect sales tax
if they have over $50,000 of in-state sales derived from referrals from La. residents.
Calif., Ga., N.C. and many other states have passed laws based on similar principles.
Some states are forcing more reporting obligations on out-of-state sellers.
Colo. and Okla. are prime examples. To assist in enforcing use tax in Colo.,
the state requires out-of-state retailers to annually report to the state and customers
on sales that exceed $500. In Feb., a federal appeals court OK'd the validity of the law.
Just last month, Okla. enacted a similar law imposing reporting on more e-tailers.
Tenn. is poised to join the ranks of states without an individual income tax. It now imposes a tax only on interest from notes and bonds and dividends. A recently enacted law lowers the tax rate to 5% (from 6%) for 2016 and cuts it further for later years, until the tax is eliminated beginning in 2022. Currently, seven states have no individual income tax: Alaska, Fla., Nev., S.D., Texas, Wash. and Wyo.

The Labor Dept.’s fiduciary rules for retirement advisers are under attack. In April, DOL issued regulations requiring more 401(k) and IRA paid advisers to act in their clients’ best interests when giving investment advice. These rules are controversial and have been opposed by some lawmakers and industry groups. The House and Senate voted to prevent the new rules from going into effect. President Obama vetoed the bill, but some groups have filed legal challenges. The U.S. Chamber of Commerce and several financial services groups asked a court to toss the regs, claiming they're unconstitutional and beyond Labor's authority. Other organizations that filed similar lawsuits also want the regulations thrown out.

Wondering what IRS agents look for when they audit retirement plans? Large participant loans are a key examination issue. During an audit, IRS checks how plans handle loans, such as the time they allow for repayment, and what happens upon default. Agents ask for copies of signed loan agreements and promissory notes, as well as documentation to substantiate residential loans. Generally, plan loans are tax-free if the total doesn't exceed the smaller of $50,000 or 50% of the account balance. Excess loans are treated as taxable distributions. Among the most common plan loan failures: Loans over $50,000. Nonresidential loans in which the repayment period exceeds five years. Loans used to buy or construct a principal home can be paid back over a longer time. And loan defaults, in which the participant fails to make the payments.

Community property interests are disregarded when applying IRA rules. A couple lived in a community property state. When the husband died, their child inherited his IRA as the named beneficiary. The wife then sued the estate for her community property interest, and a state court ordered that a portion of the IRA be assigned to her as a spousal rollover. IRS denied her request for a private ruling that she be treated as the payee of the account and that the assignment qualify as a tax-free rollover. According to IRS, any assignment of the child’s inherited IRA to the wife would be treated as a taxable distribution of the funds to the child. Also, a transfer of the money to an IRA for the wife would be an excess contribution.

IRS’s proposed rules on basis reporting by taxable estates are getting flak. As we previously noted, a 2015 law requires executors of taxable estates to report the value of inherited assets to heirs and to the Service within 30 days of the due date of the estate tax return. Form 8971 is to be used to make the reports. In March, the agency issued proposed regulations setting forth additional details. Of particular concern to tax pros: Requiring heirs to report asset transfers. Under the regulations, if heirs who inherit assets that are subject to basis reporting later gift the property to relatives, they must report the new owner and the basis to IRS. Groups such as AICPA and the American College of Trust and Estate Counsel want this requirement axed, saying that IRS exceeded its authority in proposing it.

Maintaining a private road doesn’t qualify an organization for tax exemption. Four homeowners formed the group to pay for the yearly upkeep of the road, which serves as the common driveway to their homes. To qualify as tax-exempt, a homeowners association must serve the public good over a sufficiently wide area. Because the group operates for the private benefit of its members, and its only income is from fees levied on the owners, the Service rejected its exemption application.
A reduction of debt on a dealer’s real property doesn’t net a tax break. The waived amount can’t be excluded from income as a discharge of debt on business real estate, IRS says. The rule that relieves noncorporate taxpayers of income from discharged mortgages on business realty doesn’t apply to those who hold the property primarily for sale. In one of the revenue ruling’s fact patterns, a developer who gets a mortgage to build and subdivide property into lots held for sale and later gets the lender to reduce the indebtedness owes tax on the waived debt. The rule differs for developers who hold the mortgaged realty for use in their business... such as leasing units in an apartment building they constructed. The canceled debt is tax-free, and they reduce their depreciable tax basis in the building accordingly.

IRS affirms a rule for entities that are disregarded for federal tax purposes: Owners must be bankrupt or insolvent to exclude income from waived debts. Some solvent taxpayers had claimed they got the break if their disregarded entities were underwater. But IRS rejects this argument in final regulations. A disregarded entity is a business with a single owner that elects not to be taxed as a separate entity, such as a one-member LLC. Instead, income or loss is reported on the owner’s return.

A Senate bill would make some discharged student loans tax-free. The Department of Education forgives student loans for individuals who die or become permanently disabled. Under current tax rules, the waived debt is reported on IRS Form 1099-C and is generally treated as taxable income. A bipartisan group of senators has introduced legislation to make it nontaxable.

An insider trader doesn’t get a tax write-off for forfeiting his profits. A former executive was convicted of insider trading and sentenced to jail. He was also forced to return the stock sale gains that were derived from his crime... profits that he had reported as taxable income on his prior-year tax return. After he claimed a loss deduction when he paid back his ill-gotten gains, IRS balked. In 2014, a federal trial court rejected the Service’s argument that the forfeited gains rose to the level of a nondeductible fine or penalty. But an appeals court in D.C. has now reversed that decision and disallowed his loss (Nacchio, Fed. Cir.).

IRS and the courts can be sticklers on allowing business mileage write-offs. A taxpayer used his personal auto in his business of marketing petroleum properties. For some activities, he kept a meticulous log with the exact miles driven, destination and purpose. For other trips, he wasn’t so precise, either estimating his mileage or failing to list the place he drove to. The Tax Court approved the business miles for which he had detailed records and nixed the rest (Powell, TC Memo. 2016-111).

Excessive borrowing on a life insurance policy causes tax woes for the owner. He paid the premium up front and borrowed against the policy’s cash value. But when his loans exceeded the cash value, the insurer followed the policy’s terms and canceled it. The Tax Court agreed with IRS that he owes tax on the difference between his total debt and his investment in the policy (Mallory, TC Memo. 2016-110).

Proving taxpayers acted fraudulently isn’t always an easy task for IRS. An agent found evidence of unreported income and overstated expenses when he audited a return preparer and his wife. The examiner also looked at returns that the husband prepared for two clients and found similar errors. IRS alleged that his preparation of those returns established a pattern of fraudulent conduct that he used in doing his own returns. But the Tax Court said the couple’s actions, while negligent, did not rise to the level of fraud (Ericson, TC Memo. 2016-107). Absent fraud, the limitations period had expired on two of the three years under audit. So the taxpayers owe additional taxes and penalties only for the single open year.
This election season, many people will get paid for working at the polls. Their compensation is taxable. But income tax withholding isn’t required unless the worker requests it by giving a completed W-4 to the state or municipality. FICA tax generally doesn’t apply if workers are paid less than $1,700 in 2016. If their wages are $1,700 or more, then FICA tax applies from the first dollar paid. In some localities, however, a lower wage level could trigger FICA tax withholding.

A state’s payments to caregivers to defray costs of in-home care are tax-free, the Service says in a private ruling. State Medicaid programs pay for the cost of a caregiver’s home-based services provided to aged, blind or disabled individuals who would otherwise require institutional care. Family members may be caregivers under the programs. The aid qualifies as nontaxable difficulty-of-care payments.

IRS has reopened its Web tool for individuals to get tax transcripts online. But you’ll have to jump through a series of hoops to gain access to it. Stiffer authentication procedures have been added to the Get Transcript application to thwart future hack attacks. You’ll need a cell phone to receive a text message with a six-digit activation code. The tool will let you view and print your transcript. It’s expected that many people will struggle with the authentication process.

Some filers who claim the earned income credit could see delayed refunds. Ditto for people taking the refundable child credit. Changes enacted last year mandate that, starting with 2016 tax returns, the Service must wait until Feb. 15 before doling out refunds to these filers. Lawmakers hope this will give IRS more time to help stem the flow of dollars lost because of refund fraud and tax identity theft.

Nonresidents seeking refunds of withheld U.S. tax will soon see their money. The Revenue Service has held up thousands of refunds claimed on 1040NR returns for six months or more, as examiners sought to verify that the amount of withholding claimed by the filer matched that reported by the withholding agent on Form 1042-S. Many of the affected returns were filed by foreign students attending U.S. universities. The agency says a software glitch flagged returns with little risk of erroneous refunds. It’ll now process the long-delayed returns and issue checks...with interest, if applicable.

Considering leaving the U.S. if your nightmare candidate wins in Nov.? A growing number of people claim that they will move outside the U.S. if Donald Trump becomes president. Others want out if Hillary Clinton is elected. If you move but keep your citizenship, the U.S. will continue to tax you. The U.S. taxes its citizens on their worldwide income, no matter where they reside. You also won’t be able to escape the rules on reporting foreign bank accounts. Folks who decide to give up their U.S. citizenship could owe an exit tax if their average annual tax for the five years before expatriating exceeds $161,000 or they have at least $2 million of net worth. They’ll be treated as selling all their assets for fair market value on the day before their expatriation date and will be taxed on the profit from the deemed sale that exceeds an exemption of nearly $700,000.

Yours very truly,

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THE KIPLINGER WASHINGTON EDITORS

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