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Confusion Over Rules from the IRS – Chaos in Tax Land

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A healthy, efficient and functional tax system is one that should be predictable. In a nation that prides itself on the rule of law, it is the legislature that passes laws which are administered by the executive branch and interpreted by the judicial branch. Unfortunately, that process is breaking down before our eyes. We would offer three very recent examples of confusion and chaos sown by Congress and amplified by the Internal Revenue Service.

Our favorite example involves the rules for required minimum distributions from inherited IRAs. The 2019 Secure Act, which was passed in a rushed fashion by a Congress anxious for its holiday break, changed the rules for inherited IRAs and instituted a new "10 year" rule. In the good old days, a Congressional committee would have debated and marked up a proposed bill. Those committee reports would inform Congress in its eventual vote on the proposed legislation. If the bill became law, those committee reports would be considered key guidance in interpreting the new law. Sadly, that is not the way a bill becomes law today. With a rush to vote, committee reports no longer clarify legislative confusion.

With regard to the new "10 year" rule, an ordinary reading of the statute suggested that an inherited IRA had to be liquidated within ten years of the death of the account owner. Tax experts read that to mean that a beneficiary could take funds out all at one, or in small increments, as long as the account was liquidated after a decade. In February 2022, however, the IRS issued proposed regulations that reached the opposite conclusion: according to the IRS, a beneficiary would have to take annual distributions (calculated in a most illogical fashion) and then remove whatever assets existed in year 10. Most commentators thought this was an odd rule, but it was the rule. Taxpayers may not like the rule, but we can adapt as long as we know the rule.

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Despite the confusion, taxpayers began to comply with the new interpretation until the IRS changed its position again. The silliness is captured in the following headline:

"IRS NOTICE 2023-54 PROVIDES WELCOME RELIEF TO 10-YEAR RULE BENEFICIARIES AND RETIREMENT ACCOUNT OWNERS BORN IN 1951"

Relief takes the form of the IRS saying, in essence, never mind what we told you about the rules for 2021, 2022 and 2023. Don't worry about taking distributions. But you might have to take them for 2024. We aren't sure yet, but we will let you know soon. Suffice to say, this makes planning to comply with the law very difficult. We hope the IRS gets this issue right and clarifies their position once and for all. We are not, however, very hopeful.

Our second example of tax chaos also came from the IRS last month and is likely not legal. As part of year end tax legislation that was rushed through Congress in December 2022, wage earners with incomes above $145,000 (who comes up with these numbers?) were going to have to make "catch up" 401(k) contributions to a Roth 401(k). This effectively increases the current tax bite on those contributions. Once again, we don't have to like the law, but it was clear that this was what Congress included in the bill. There was no room for IRS interpretation.

This ill-considered and hastily passed rule created chaos for many plans and payroll providers. Had Congress gone through its normal process, this would have been considered in committee hearings. Instead, it came up after the law was passed. After months of complaint and protest, the IRS last month announced that they were delaying the changes on catch up contributions until 2026.

This administrative fix should give enough time to all those impacted to make the necessary changes and comply. While that is good, and we are happy for this outcome, we would suggest that this is illegal. Congress passes laws, not the IRS. If there is to be a delay in implementation, that should happen through legislation, not arbitrary rule making. It is doubtful that anyone will challenge this matter and is unlikely that anyone can find standing to sue in court, but it strikes us as painfully poor policy making.

Our final exhibit in the case for tax chaos involves IRS guidance regarding state tax payments. In Colorado, for the last thirty years, the Tabor amendment has limited the growth of state expenditures. When state revenues exceed a combination of inflation and population growth, excess amounts are required to be refunded to taxpayers. Those payments are arguably a combination of all sorts of taxes and fees that the state collects. Never have the refunds been deemed taxable income, until now.

Last February, the IRS asserted that these refunds should be taxable. There were howls of outrage from the Colorado Congressional delegation and the IRS backed off because it was tax filing season. Now, however, the IRS is back with the same interpretation. Governor Polis and the Congressional delegation are not happy, but when you make tax policy like a banana republic, you get banana republic results.

We are sure that we are overlooking many other examples of an increasingly broken and dysfunctional tax system, but these three cases seem to us good examples of how the system should not work. As citizens and taxpayers, we all have the right to demand better from Congress and the IRS. In the meantime, we will continue to work to keep abreast of these changes and help you to plan for and comply with the ever-shifting rules.