

## U.S. TREASURY TO REVIEW AND RE-EVALUATE TAX REGULATIONS

The Treasury Department plans to undertake a review and re-evaluation of tax regulations issued by the IRS since January 1, 2016. President Trump signed Executive Order 13789 (“Identifying and Reducing Tax Regulatory Burdens”) ordering this action. Following its review and re-evaluation, the Treasury Department will make recommendations.



### TAX REGULATIONS

The IRS typically issues numerous regulations every year. Some regulations are permanent, others are temporary, and others are proposed. IRS regulations touch every taxpayer, including individuals, businesses, and tax-exempt organizations. When the IRS proposes a regulation, it invites public comments. The federal government maintains a website where individuals can review proposed regulations and make comments. Frequently, the IRS will hold a hearing at which stakeholders and taxpayers can share their concerns about proposed regulations. All regulatory documents are published in the Federal Register.

### PRESIDENT’S INSTRUCTIONS

Under Executive Order 13789, the Treasury Department’s focus is to identify tax regulations that:

- impose an undue financial burden on taxpayers;
- add undue complexity to federal tax laws; or
- exceed the statutory authority of the IRS.

The Treasury Department plans to make an initial report within 60 days. After that, it will recommend what actions to take, which may include delaying, suspending, or modifying regulations. The second report is due within 150 days. Our firm will keep you posted of developments.

### IRS GUIDANCE PLAN

At the same time the President announced his Executive Order, the IRS requested public input on its new Priority Guidance Plan. This plan identifies guidance projects that are high on the agency’s agenda. Generally, these projects cover a wide range of taxpayers and tax administration. In its announcement, the IRS noted that “input is of particular importance because of Executive Order 13771.”

Executive Order 13771 was signed by President Trump in January. The Executive Order generally instructs federal agencies to remove two existing regulations for every new regulation proposed. Since January, the pace of IRS guidance has slowed. Indeed, the IRS has not issued any regulations since January 20, 2017.

The IRS has posted new frequently asked questions (FAQs) and has updated some existing FAQs on its website. The agency also has released several revenue procedures. These are official statements of a particular procedure.

Additionally, the IRS has continued to issue private letter rulings. IRS Chief Counsel has posted advice memoranda. IRS officials also continue to testify at Congressional hearings and speak at trade and industry events. IRS Commissioner John Koskinen has characterized these items as “sub-regulatory” guidance. They appear to be outside the scope of Executive Order 13771. Additionally, a federal agency may determine that a regulation is outside the scope of the Executive Order. The U.S. Department of Health and Human Services (HHS) made this determination for regulations under the Affordable Care Act released in April.

For more information about this article, please contact our tax professionals at [taxalerts@windes.com](mailto:taxalerts@windes.com) or toll free at **844.4WINDES** (844.494.6337).

## INFORMATION ON CHANCES OF BEING AUDITED BY THE IRS

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The IRS has reported that audit coverage rates are at low levels. According to the IRS, the audit coverage rate for individuals fell 16 percent from year 2015 to year 2016. This 0.7 percent audit coverage rate for individuals was the lowest coverage rate in more than a decade.

### SELECTION PROCESS

The raw audit numbers, of course, do not answer the more specific question regarding “my chances of being audited by the IRS.” The IRS does very little random selection of returns for being audited these days. Computer analysis flags certain suspect items but, there again, randomly. For example, taking the home office deduction increases a taxpayer’s odds of an audit on the item, but odds remain that it still will not be pulled for audit. Another “audit trigger” is not reporting income for which an information return (Form 1099-MISC, for example) has been generated.

**Audit campaigns.** The IRS Large Business and International (LB&I) Division has revealed new corporate compliance campaigns. The campaigns, as explained by LB&I, offer “a holistic response to an item of either known or potential compliance risks.” Whether “audit campaigns” will be initiated within the other major IRS divisions will depend, in part, upon the success of the LB&I division’s rollout. So far, IRS leadership appears optimistic over its prospects.

The campaigns currently address the following:

- Internal Revenue Code (IRC) Section 48C energy credit
- Offshore voluntary disclosure program declines and withdrawals
- IRC Section 199 domestic production activities deductions

- Micro-captive insurance
- Related-party transactions
- Deferred variable annuity reserves and life insurance reserves
- Basket transactions
- Completed contract method of accounting
- TEFRA linkage plan strategy
- S corporation losses claimed in excess of basis
- Repatriation
- Form 1120-F Nonfiler



**Automatic Underreporter Program.** The IRS reported that the Automatic Underreporter Program continues to generate significant revenues. The agency closed more than 3.5 million cases under the Automatic Underreporter Program, generating some \$6.8 billion in additional assessments. Further, the IRS closed nearly 400,000 cases under the Automatic Substitute for Return Program, generating some \$600 million in additional assessments.

Intertwined with audit selection are the shrinking resources available to the IRS to conduct audits. President Trump has proposed a \$239 million reduction in the IRS's budget for fiscal year (FY) 2018.

### AUDIT COVERAGE STATS

**Individuals.** The audit coverage rate for individuals for FY 2016 was 0.7 percent. The audit coverage rate increased for higher income taxpayers: 1.7 percent for returns reporting more than \$200,000 in income and 5.8 percent for returns reporting more than \$1 million in income. Nearly 800,000 of individual audits in FY 2015 were correspondence audits. Some 240,000 were field audits. In total, the IRS audited roughly 1.03 million of the nearly 148 million individual returns filed.

**Corporations.** The audit coverage rate for corporations (excluding S corporations) for FY 2016 was 1.1 percent. Here, more audits were field audits than correspondence exams. Some 19,000 were field audits and roughly 1,800 were correspondence audits.

**Partnerships and S corporations.** For partnerships, the audit coverage rate for FY 2016 was 0.4 percent. The IRS audited roughly 15,000 of the 3.9 million partnership returns received. The audit coverage rate for S corporations for FY 2016 was 0.3 percent. Of the approximately 4 million S corporation returns received, the IRS selected some 16,000 for audit.

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# DIFFERENTIATE TIPS FROM SERVICE CHARGES FOR TAX PURPOSES



Although the employee may end up with the same amount whether something is designated a tip or a service charge, the IRS reporting requirements for the employer do differ. Basically, any amount required to be paid by a customer rather than at the customer's discretion is considered a service charge by the IRS.

## TIPS

Tips are optional payments received by employees and determined by customers. Tips include cash; tips made through a credit card or other electronic payment; the value of noncash tips; and tips paid through tip-splitting.

Tips include the following:

- Cash tips received directly from customers
- Tips from customers who leave a tip through electronic settlement or payment. This includes a credit card, debit card, gift card, or any other electronic payment method.
- The value of any noncash tips, such as tickets, or other items of value
- Tip amounts received from other employees paid out through tip pools or tip splitting, or other formal or informal tip sharing arrangements

Employees are required to report cash tips to their employers except tips from any month that total less than \$20. Employers are required to retain employee tip records and credit card tip designations, withhold employee income taxes and the employee share of social security and Medicare taxes, and report this information to the IRS.

Both directly and indirectly tipped employees must report tips to their employer. A "directly tipped employee" is any employee who receives tips directly from customers, including one who, after receiving the tips, turns all of them over to a tip pool. Examples of directly tipped employees are waiters, waitresses, bartenders and hairstylists. An "indirectly tipped employee" is a tipped employee who does not normally receive tips directly from customers. Examples of indirectly tipped employees are bussers, service bartenders, cooks, and salon shampooers.

Tips reported to the employer by the employee must be included in Box 1 (Wages, tips, other compensation), Box 5 (Medicare wages and tips), and Box 7 (Social Security tips) of the employee's Form W-2, Wage and Tax Statement. Enter the amount of any uncollected social security tax and Medicare tax in Box 12 of Form W-2.

## SERVICE CHARGES

Tips must be made free from compulsion; the customer must have the unrestricted right to determine the amount; the payment may not be subject to employer policy; and the customer has the right to determine

who receives the payment. Service charges do not have any of these qualities and are generally reported as regular wages to employees. So-called “automatic gratuities” and any amount imposed on the customer by the employer are service charges, not tips.

Examples of service charges commonly added to a customer's check include:

- Large dining party automatic gratuity
- Banquet event fee
- Cruise trip package fee
- Hotel room service charge
- Bottle service charge (nightclubs and restaurants)

Service charges are generally wages, and they are reported to the employee and the IRS in a manner similar to other wages. On the other hand, special rules apply to both employers and employees for reporting tips. Employers should make sure they know the difference and how they report each to the IRS. Generally, service charges are reported as non-tip wages paid to the employee. Some employers keep a portion of the service charges. Only the amounts distributed to employees are non-tip wages to those employees.

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## CALIFORNIA FRANCHISE TAX BOARD IS SENDING REQUESTS TO CONFIRM TAX RETURN FILING

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The California Franchise Tax Board (FTB) has seen a dramatic rise in returns that look like potential identity theft due to the increase in employer and tax professional data breaches this year, which has caused them to issue more Forms FTB 3904, Request to Confirm Tax Return Filing.

This notice is sent if the FTB highly suspects the likelihood of identity theft. Instead of sending or faxing the requested documentation, the FTB recommends calling the number on the notice immediately: (916) 845-7088. The FTB employee may be able to ask certain questions to help validate the taxpayer filed the return in order to allow the refund. If the FTB employee is not able to validate over the phone, they may require the documentation to be sent. Mailing the information is not recommended because of the time lag with mailed correspondence. The FTB is also sending Forms FTB 4734D, Request for Tax Information and Documents, when there is a question as to the taxpayer's identity.

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# TAKE TAX ADVANTAGES ON MISCELLANEOUS ITEMIZED DEDUCTIONS

Miscellaneous itemized deductions are certain nonbusiness expenses that individual taxpayers who otherwise itemize deductions may take against their taxable income. Such miscellaneous expenses are allowed only to the extent that they exceed two percent of a taxpayer's adjusted gross income. Miscellaneous itemized deductions may also be limited by the overall itemized deduction phase-out.

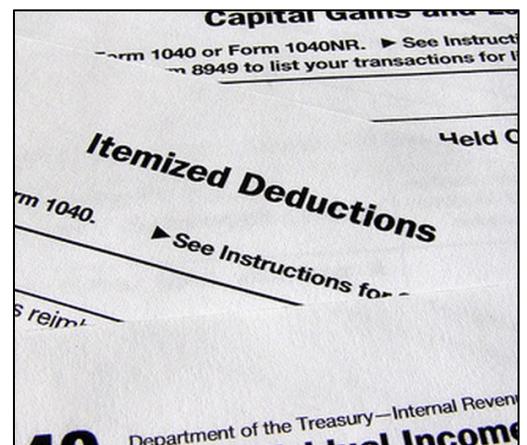
These expenses include employee business expenses, expenses of producing income, expenses related to filing tax returns and certain hobby expenses. Specifically, the miscellaneous itemized deductions available to a taxpayer are the following:

- Professional society dues
- Employment-related educational expenses
- Home office expenses
- Professional books, magazines and journals
- Work clothes and uniforms
- Union dues and fees
- A portion of unreimbursed business-related meal and entertainment expenses
- Other unreimbursed employee business expenses
- Employee expenses for which reimbursements are included in income
- Rental of a safe-deposit box
- Expenses incurred for tax counsel and assistance
- Costs of work-related small tools and supplies
- Investment expenses
- Fees paid to an IRA custodian
- Certain expenses of a partnership, grantor trust or S corporation that are incurred for the production of income

Additionally, there are some miscellaneous expenses that are not subject to the two percent of adjusted gross income limitation. These include the following:

- Bond premium amortization for taxable bonds
- Gambling losses for the year up to the extent of gambling winnings
- Casualty and theft losses associated with income-producing assets
- Federal estate tax on income in respect of a decedent

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# IS A TAX ON SNACKS AND YOUR FEES IN OUR FUTURE?

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Even with the extension of the income tax rate increases via 2016's Proposition 55, the Legislature is looking for more money. Sales tax on services and a tax on candy and snack food could become a reality - if not this year, by 2019.

## SALES TAX ON SERVICES

SB 640 (Hertzberg) seeks to realign California's tax system to rely more on sales tax revenue than income tax revenue, which the bill states will produce more stable revenue. In its current form, the bill does not impose a sales tax but makes legislative findings in response to pending proposals for federal tax reform and California's tax climate. The bill would direct the Legislature to consider:



- imposing a modest state, but not local, sales tax on services. Health care services, education services, child care, rent, interest, and services represented by "very small businesses" would be exempt;
- whether there would be "offsetting tax relief" for middle- and low-income California families;
- lowering the minimum franchise tax; and
- reducing the corporate rate on small businesses.

California already taxes a limited number of services: printing, fabrication, and some repair services. This is similar to about 13 other states that tax only these types of services, although some of these states tax one or two other services as well. Four states tax all services, unless otherwise exempted: Hawaii, New Mexico, South Dakota, and West Virginia. Hawaii is the only state that taxes all professional services. To date, Hawaii, New Mexico, and South Dakota are the only states that tax legal and accounting services.

The possibilities are endless when you consider how many types of services are out there. The District of Columbia taxes yoga and other gym/health club activities, while Washington only taxes yoga/Pilates if the class is offered in a gym. Ohio imposes a sales tax on hair removal but not on hair cutting, styling, or coloring.

In terms of the most interesting services that are specially taxed, Iowa is the winner. Iowa taxes dating services, Turkish baths, weight loss salons, and taxidermy services.

In essence, enacting this bill would be the first step toward implementing a sales tax on services. Last year's SB 1445 (Hertzberg), which did not pass the Legislature, was similar to SB 640.

## SNACK TAX

Like a phoenix rising from the ashes, AB 274 (Garcia) would, if enacted, put a proposition on the ballot to overturn Proposition 163. If the proposition were to pass, beginning in 2019, sales and use tax would apply

to the sale, or the storage, use, or other consumption in this state, of certain food products for human consumption, which include candy, confectionery, and snack foods.

The definition of a "snack" will be a nightmare. In 1991, the Board of Equalization was tasked with defining a "snack" when the State enacted the Snack Tax Fiasco of 1991, which was killed by the voters in 1992 via the passage of Proposition 163. The result of the 1991 Act was an 87-page report identifying certain snack foods as taxable (84 pages) and nontaxable (3 pages). The following is what Bob Spidell wrote in *Spidell's California Taxletter*®, August 1991 issue:

"Here are some examples that seem to have no discernable relationship to logic, common sense, or any nutritional standard known to man.

- Granola bars are taxable but granola breakfast cereal is not taxable.
- Breakfast cereals generally are nontaxable no matter how high the fat or sugar content, but breakfast bars and breakfast drinks are taxable, no matter how healthy the contents.
- Seeds, nuts, raisin, and granola are not taxable by themselves, but they become taxable when combined into a trail mix.
- Candy and candy bars are taxable, but ice cream and ice cream bars are not taxable.
- Neither cheese nor soda crackers are snack foods, but put them into one package and they magically become a taxable snack food.
- Size also has some mysterious effect. Soda crackers are not taxable, but soup and oyster crackers are taxable even if you plan to drown them in nontaxable soup.
- Candy sold through vending machines is taxable at the full selling price. However, cold food products (e.g., cold sandwiches, milk, or apples) are still partially exempt under the prior law, which did not change.
- Candy and glazed fruit that are used in cooking and baking are not subject to sales tax. Apparently, buyers are on the honor system not to cheat..."

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