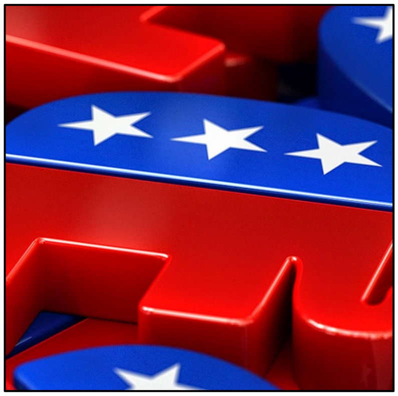
Tax Alerts

March 2017

Discussion on 2017 Tax Reform



The change in administrations in Washington has generated a new focus on tax reform. The White House and lawmakers from both parties have discussed tax cuts, infrastructure spending, and more to encourage economic growth. However, the details of their plans have yet to be revealed.

Tax reform

President Trump campaigned on tax reform and Republican lawmakers in the GOP-controlled Congress, especially in the House, have endorsed many of his proposals. House Republicans also have their own "blueprint" for tax reform. At the time this article was prepared, neither the White House nor House Republicans had released specific bill language. However, based on statements from the president and House Republicans, tax reform legislation in the House is expected to include:

- Consolidated and lower individual income tax rates
- Reduced corporate tax rate
- Elimination of the alternative minimum tax (AMT)
- Some new tax incentives for childcare and eldercare
- Elimination of some unspecified individual and business tax incentives
- Repeal of the federal estate tax

House Speaker Paul Ryan, R-Wisconsin, predicted that the House will approve a tax reform package within the first 200 days of 2017. At the same time, Ryan acknowledged that the Senate operates under different rules and legislation and often moves at a slower pace. In past years, the House and Senate have played ping pong with tax bills, with the House passing a bill, the Senate amending it and returning it to the House, and so on. That process could repeat itself this year.

Affordable Care Act

President Trump also campaigned on repeal and replacement of the Affordable Care Act (ACA). The ACA was not only a health care bill; it was also a tax bill. The ACA created many new taxes, including the net investment income (NII) tax, the additional Medicare Tax, the excise tax on medical devices, and the excise tax on high-dollar health plans. These taxes, especially the NII tax, have generated significant revenues for the federal government.

The president previously said that repeal and replacement of the ACA would be "simultaneous" but gave few details about what a new health care bill would look like. The president has mentioned, briefly, expanding health savings accounts (HSAs). House Republicans also have discussed HSAs. In the Senate, one GOP proposal would allow states to keep the ACA. House Minority Leader Nancy Pelosi, D-California, has said that any ACA replacement must meet the fundamental principles of the ACA to win support from Democrats.

Infrastructure

Democrats and Republicans, along with the White House, have discussed increased spending on infrastructure in 2017. Infrastructure could include some unspecified tax incentives. South Dakota Republican Senator John Thune said that infrastructure spending could be part of a larger tax bill, but he gave no specifics.

IRS

Shortly after taking office, President Trump ordered a hiring freeze for federal employees. Traditionally, the IRS hires many temporary workers during the filing season to answer calls from taxpayers and help to process returns. It is unclear how the president's order will impact the IRS's hiring plans, if at all. Since 2010, the IRS has limited full-time hiring in response to budget pressures.

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National Taxpayer Advocate Calls for Taxpayer-Centric IRS

National Taxpayer Advocate Nina Olson, in a recent report to Congress, urged the IRS to change its culture from one that is enforcement-oriented to one that is service-oriented. Such a change, Olson provided, would create an environment that encourages taxpayer trust and confidence. In the report, Olson also highlighted key areas for tax simplification and the top 10 most litigated tax issues.

2017 Filing Season

During the 2017 filing season, like recent past filing seasons, the IRS will face challenges related to budgetary pressures. Each year, the IRS must deliver a filing season in which it processes some 150 million individual tax returns and issues more than 115 million refunds while guarding against identity theft and refund fraud, Olson told lawmakers. "At the same time, the IRS must incorporate new legislative changes — almost 5,900 since 2001, an average of more than one a day— and major new programs like the *Affordable Care Act (ACA)* and *the Foreign Account Tax Compliance Act (FATCA)*," Olson said.

Olson told lawmakers that the IRS focuses on what it considers its major obligations — the filing season, new legislation, and the area of information technology and cybersecurity. "The consequences of this 'big item' focus are that smaller, important, taxpayer-facing service is reduced or eliminated."

Enforcement

Olson criticized the IRS's current enforcement-oriented regime, citing the major problem with such an approach is that it undermines the willingness of taxpayers to comply by expending most resources on those who are not willing to comply. "If a tax agency views its primary mission as 'enforcing' the tax laws, it will design its procedures and apply its resources to 'hunt down' those taxpayers it views as noncompliant," Olson told lawmakers. Accordingly, those who are willing to comply are left without adequate support, Olson said.

Although Olson stated that the IRS should not ignore those taxpayers who are actively evading tax, the IRS should design the tax system around those who are trying to comply. As such, Olson recommended that the IRS publish an annual report card on comprehensive measures that not only show traditional enforcement measures but disclose how the agency performed in providing assistance and service in meeting taxpayer needs and preferences, as well as increasing voluntary compliance over time. These measures, in turn, should form the basis for executive performance commitments and assessments, Olson predicted.

Challenges facing the IRS

In the report to Congress, Olson identified seven challenges confronting the IRS. The challenges are as follows:

- **IRS budget and oversight**. To fairly, effectively, and efficiently administer the tax system, the IRS must receive increased funding, but such funding should be tied to additional congressional oversight of IRS strategic and operational plans.
- **IRS culture**. To create an environment that encourages taxpayer trust and confidence, the IRS must change its culture from one that is enforcement-oriented to one that is service-oriented.
- **IRS mission statement**. To ensure the IRS recruits, hires, and trains employees with the appropriate skill sets, the IRS must revise its mission statement to explicitly acknowledge the IRS's dual mission of collecting revenue and disbursing benefits, as well as the foundational role of the Taxpayer Bill of Rights.
- **Understanding taxpayer needs and preferences**. To ensure that the IRS designs its current and future state initiatives based on actual taxpayer needs and preferences, the IRS must actively and directly engage with the taxpayer populations it serves as well as undertake a robust research agenda that furthers an understanding of taxpayer compliance behavior.
- **Taxpayer rights**. To ensure that taxpayer rights, and the Taxpayer Bill of Rights, specifically, are the foundation for tax administration, the IRS should undertake a comprehensive review of key taxpayer rights provisions in the Internal Revenue Code (IRC) and issue proposed guidance for public comment, updating these provisions to protect taxpayer rights in the digital environment envisioned by the IRS Future State.
- **Technology and infrastructure**. To enable the IRS to meet the major technology improvements required for a 21st century tax administration, even as it fulfills current operational technology demands, the IRS must articulate a clear strategy that will reassure Congress and taxpayers that the funding will be well-spent.
- **Taxpayer Advocate Service**. To protect taxpayer rights and ensure a fair and just tax system, Congress should take steps to strengthen the Taxpayer Advocate Service.

TAX SIMPLIFICATION

Olson stressed that tax simplification is overdue. "To achieve comprehensive simplification, tax expenditures would be pared back substantially and the additional revenue would be used to substantially reduce tax rates, leaving the average taxpayer with about the same tax bill he or she has now — but with the ability to compute it much more simply and accurately," Olson told lawmakers. In the report, Olson identified nine areas for tax simplification to include repealing the alternative minimum tax (AMT) for individuals and reducing income phase-outs, which affect roughly half of all returns each year and add considerable complexity to tax computations.

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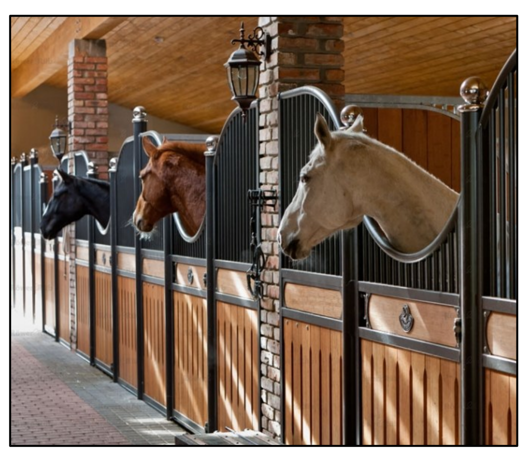
ESTABLISH PROFIT MOTIVE FOR BUSINESS ACTIVITIES AND AVOID HOBBY LOSS LIMITATION

The IRS has rules that limit the deductibility of expenses and losses from a hobby or activity not engaged in for profit. If the IRS determines that an activity is not profit-driven, deductions from the activity are limited to the amount of income the activity generates. Losses from such activities cannot be used to offset other income, such as salary or investments.

In being able to deduct a net loss from a business — whether it is a business that normally has ups and downs or one in which the unexpected might occur — you must be prepared to show that an activity that generates deductions is a business from which you intend to profit. It is not necessary for the activity to actually earn a profit, so long as a profit is one of the motives for participating in the activity. The IRS assumes that an activity is carried on for profit if it makes a profit during at least three of the last five tax years, including the current year, or at least two of the last seven years for activities that consist primarily of breeding, showing, training, or racing horses. Otherwise, the IRS applies non-exclusive tests and factors to the surrounding facts to judge whether activities are more like a business with a profit motive, or are for personal satisfaction. Under IRS rules and judicial precedent, the following nine factors are considered in determining whether an activity is engaged in for profit:



1. The manner in which the taxpayer carries on the activity
2. The expertise or experience of the taxpayer's advisors
3. The time and effort the taxpayer expends on the activity
4. The expectation that the assets used in the activity may appreciate in value
5. The success of the taxpayer in carrying on other similar or dissimilar activities

6. The taxpayer's history of losses from the activity
7. The amount of occasional profits earned from the activity
8. The taxpayer's financial status
9. The elements of personal pleasure or recreation derived from the activity

These factors are not exclusive in determining a profit motive, and if the circumstances warrant, are not given any weight.

To make sure you are properly claiming all of the deductions available to you, and to strengthen your position in the event of an IRS audit, it is important to consider all the facts and circumstances surrounding activities the IRS is likely to challenge.

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Transferee's Tax Liability

The prudent businessperson is always cautious when he or she is offered a great bargain on real estate, equipment, a business interest, or some other property that just might be too good to be true. Even in connection with ordinary business transactions, but especially when considering taking over a property or business that is a bargain because of some legal wrinkle, you should consider whether there might be some tax liability attached to the bargain that could come back to haunt you down the road.

Transferee liability

An individual or a business entity that receives property from a taxpayer may be liable for the tax the taxpayer owes. The IRS may be able to assess and collect the tax from the new owner of the property even though the previous owner incurred the tax liability. This concept is referred to as "transferee liability" and its consequences are possible whether the transferred property was purchased or was a gift.

Who is a transferee?

The term "transferee" includes an heir of an estate of a deceased person, the assignee or donee of an insolvent person, the shareholder of a dissolved corporation, the successor of a corporation, a party to a corporate reorganization, and all other classes of distributees. The IRS can assess and collect income, estate, gift, and other taxes, including excise taxes and withholding taxes from the transferee. Other taxes also subject to transferee liability include Federal Insurance Contributions Act (FICA) and federal unemployment taxes where the tax liability arises when a partnership or corporation liquidates or a corporation reorganizes.

Federal tax lien

If a taxpayer fails to pay an assessed tax, the tax due amounts to an implicit lien in favor of the United States. This tax lien is effective against all of the taxpayer's property, including after-acquired property as well as property that the taxpayer transferred away for less than full consideration. Where there is a tax

lien, the government can either bring an action to set aside the transfer for less than full consideration as a fraudulent conveyance, then foreclose on the property to satisfy the tax, or it can assert transferee liability and extract the tax due from the transferee.

Types of transferee liability

The IRS is not the only creditor that could seek satisfaction for a debt owed by the person who transferred away the asset. Other creditors may also have equitable, statutory and contractual rights regarding transferred property. Contractual transferee liability arises where there is an agreement among the parties regarding how debts will be settled. Statutory transferee liability is based on state or federal laws. Equitable liability arises, in general, where there is a fraudulent conveyance of property from the transferee.

IRS's power to collect

Generally, to hold a person or business liable for another taxpayer's delinquent taxes under the transferee liability rules, the IRS must show that (1) the transferee received assets from the transferor-taxpayer, and (2) the transferor was insolvent at the time of, or was rendered insolvent by, the transfer. The IRS can impose liability on the transferee either through an administrative proceeding, or it can bring a lawsuit to set aside the property transfer as a fraudulent conveyance. And it is possible that the transferee's liability could be for more than the value of the transferred assets. As with most tax controversies, however, there may be an opportunity to reach a settlement with the IRS. Before going forward with any contemplated transaction, especially one that involves a substantial sum, it is best to consider the potential hidden costs.

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Federal Automatic Six-month Extension for C Corporations

The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 established new due dates for Form 1120 (U.S. Corporation Income Tax Return). For tax years beginning after December 31, 2015, the Form 1120 due date is generally April 15 for calendar-year corporations, with an automatic five-month extension allowed (to September 15). However, under Internal Revenue Code (IRC) Section 6081(a), the IRS may grant a reasonable extension (generally limited to six months) for filing any return. The IRS has released draft instructions for Form 7004 (Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns) that grant an automatic six-month extension (to October 15) to calendar-year C corporations rather than the statutory five-month extension. It appears that the IRS is using its authority under IRC Section 6081(a) to allow for a longer extension period.

Most of the states had conformed to the change in the federal due date for the C corporations. However, there are few states that have not conformed to the change. Please visit the AICPA website for the updated status on state conformity at www.aicpa.org.

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Do Not Fall for Scam Calls and Emails Posing as the IRS

Scams continue to use the IRS as a lure. These tax scams take many different forms. The most common scams are phone calls and emails from thieves who pretend to be from the IRS. Scammers use the IRS name, logo, or a fake website to try and steal money from taxpayers. Identity theft can also happen with these scams.

Taxpayers need to be wary of phone calls or automated messages from someone who claims to be from the IRS. Often these criminals will say the taxpayer owes money. They also demand payment right away. Other times scammers will lie to a taxpayer and say they are due a refund. The thieves ask for bank account information over the phone. The IRS warns taxpayers not to fall for these scams.

Below are several tips that will help filers avoid becoming a scam victim.

IRS employees will NOT do the following:

- Call demanding immediate payment. The IRS will not call taxpayers if they owe tax without first sending a bill in the mail.

- Demand payment without allowing the taxpayer to question or appeal the amount owed.
- Require that taxpayers pay their taxes a certain way. For example, demand taxpayers use a prepaid debit card.
- Ask for credit or debit card numbers over the phone.
- Threaten to contact local police or similar agencies to arrest the taxpayer for non-payment of taxes.
- Threaten legal action such as a lawsuit.

If taxpayers do not owe or do not think they owe any tax, they should do the following:

- Contact the Treasury Inspector General for Tax Administration (TIGTA). Use TIGTA's "IRS Impersonation Scam Reporting" web page to report the incident.
- Report the incident to the Federal Trade Commission (FTC). Use the "FTC Complaint Assistant" on www.FTC.gov. Please add "IRS Telephone Scam" to the comments of your report.

In most cases, an IRS phishing scam is an unsolicited, bogus email that claims to come from the IRS. Criminals often use fake refunds, phony tax bills, or threats of an audit. Some emails link to sham websites that look real. The scammer's goal is to lure victims to give up their personal and financial information. If they get what they are after, they use it to steal a victim's money and identity. For those taxpayers who get a 'phishing' email, the IRS offers this advice:

- Do not reply to the message.
- Do not give out your personal or financial information.
- Forward the email to phishing@irs.gov. Then delete it.
- Do not open any attachments or click on any links. They may have malicious codes that will infect your computer.

The IRS also recently announced that taxpayers must be prepared to validate their identities when speaking with an IRS assistor. Preparation will help to avoid a repeat call at one of the IRS's busiest times of year. Before calling about a personal tax account, taxpayers must have the following information handy:

- Social Security Numbers and birth dates for those listed on the tax return
- An Individual Taxpayer Identification Number (ITIN) for those without a Social Security Number
- Filing status (Single, Head of Household, Married Filing Joint or Married Filing Separate)
- A copy of the tax return in question
- Any letters or notices received from the IRS

Deceased Taxpayer

For inquiries about deceased taxpayers, individuals must be prepared to fax the deceased taxpayer's death certificate and either copies of the Letter of Representation approved by the court or IRS Form 56, Notice Concerning Fiduciary Relationship (for estate executors).

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Top Five California Franchise Tax Board (FTB) Audit Programs

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The FTB has an active audit program. The top five issues are as follows:

1. **Capital gains and losses**: Audits check whether gains and losses were reported correctly for a variety of audit issues, including sale of stock, business property, casualty losses, and amounts flowing through from passthrough entities.

2. **Like-kind exchanges**: Issues include erroneous boot calculations, improper property identifications, and failure to meet other deferral requirements.

3. **Head of household filing status**: Common errors include the qualifying individual's income exceeding the gross income test and taxpayers who do not meet the requirements to be considered married or considered not a registered domestic partner (RDP).

4. **Employee business expenses**: The FTB may ask taxpayers claiming unreimbursed employee business expenses to provide documentation to substantiate their employer's reimbursement policy to determine whether their expense is allowable.

5. **Shareholder/partner/owner's basis in a passthrough entity**: Audits check the correct reporting of flow-through items and amounts reported on the sales of interests in passthrough entities.

There are a number of other programs, including residency. There are also other issues on which the tax-payers have been receiving correspondence/audit notices, such as other state tax credits, apportionment, and enterprise zone tax credits, to name a few.

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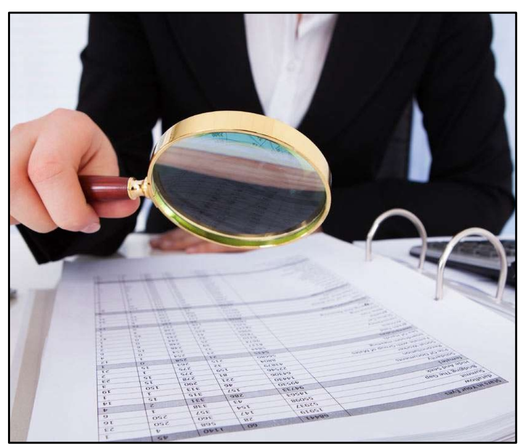

Phishing Fraud Spreads During Tax Season

The Internal Revenue Service (IRS) is once again warning employers, payroll and tax professionals to be extremely vigilant of the following three specific fraudulent schemes designed to trick taxpayers into thinking these are official communications from the IRS, tax professionals, company officials, or tax software companies:

1. **IRS/ACA Scheme**: Target receives an email or letter that includes a fake CP2000 report. The fraudulent notice includes a payment request that taxpayers mail a check made out to "I.R.S." at the "Austin Processing Center" at a P.O. Box address.

2. **Fraudulent Software Providers**: Tax professionals receive emails that request they download and install an important software update via a link included in the email. The recipient believes he or she has downloaded a software update when, in fact, the person has loaded a program designed to track keystrokes. This program can steal login information, passwords, and other sensitive data.

3. **W-2 Phishing Scam**: Targets payroll and human resource professionals by email. The emails pretend to be from company executives and request personal, sensitive information on employees. The email contains the actual name of the company chief executive officer or other C-level executive. The email from the "CEO" requests a list of employees' personal information including Social Security Numbers. The IRS urges company payroll officials to double check any executive-level or unusual requests for lists of Forms W-2 or employee names and Social Security Numbers.

Organizations receiving a W-2 scam email should forward it to phishing@irs.gov and place "W2 Scam" in the subject line. Organizations that receive these types of fraudulent schemes or fall victim to them should file a complaint with the Internet Crime Complaint Center operated by the Federal Bureau of Investigation.

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