Tax Alerts

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Information Reporting Deadlines Coming Up Fast

Information reporting has become a growing part of the IRS's enforcement and compliance strategy. Data matching, or even the inference that the IRS has the data to do so, statistically has increased overall income reporting nine-fold. Use of information returns, either in the form of Forms W-2, 1098s or 1099s, is here to stay, and growing.

Each year, new information compliance requirements arrive at the start of another filing season. The filing season coming up will be no exception, with or without tax reform. Developing rules for the "sharing economy" as well as relatively new deadlines imposed under the Protecting Americans from Tax Hikes Act of 2015 (the PATH Act), all get vetted again this January. Preparing for those deadlines, especially those rapidly coming up at the end of January, needs to start soon.

Earlier W-2s and 1099s

Under the PATH Act, employers are now required to file their copies of Forms W-2 with the Social Security Administration by January 31. This deadline also applies to certain Forms 1099-MISC reporting nonemployee compensation, such as payments to independent contractors, regardless of whether the returns are filed on paper or electronically. Further, only one 30-day extension to file Form W-2 is now available and this extension is not automatic (for more, see the instructions to Form 8809). Having these Forms W-2 and 1099 in hand earlier, at least theoretically, makes it easier for the IRS to verify the legitimacy of tax returns and properly issue refunds to eligible taxpayers, but they do make for a busy January in many accounting and compliance departments.

"Gig" or "Sharing" Economy

One major area in need of clarification involves reporting under Internal Revenue Code (IRC) Section 6050W, Returns Relating to Payments Made in Settlement of Payment Card and Third-Party Network Transaction. In particular, a tighter definition of a third-party payment network (for example, for ride-sharing applications) is being called for as necessary to prevent abuse, especially since the de minimis threshold for Form 1099-K reporting under IRC Section 6050W is high.

Entities that qualify as third-party service organizations (TPSOs) are eligible for de minimis rules that eliminate reporting on otherwise reportable amounts if either the amount paid to any service provider within a year does not exceed $20,000 or the aggregate number of such transactions does not exceed 200. This exception can completely eliminate the obligation on the part of a TPSO to issue Forms 1099-K to many "part-time" payees in such areas as ridesharing.

When read with the current Instructions for Form 1099-K, the de minimis rules are being interpreted by some taxpayers as eliminating any further obligation on the part of a TSPO to report at all, including issuing a Form 1099-MISC. Payments for more than $600 for services provided by nonemployees are generally reported to the IRS on a Form 1099-MISC by a payor, with a copy provided to the service provider. However, the instructions on Form 1099-K simply say that TPSOs are required to report on service providers only if the $20,000-or-200-transactions level is reached.

Employee versus Independent Contractor

Generally, employers must withhold income taxes, withhold and pay social security and Medicare taxes, and pay unemployment tax on wages paid to employees. Information reporting to the IRS differs depending upon whether the service provider is an employee or a contractor. Whether a worker is an employee or an independent contractor depends on a number of factors.

The IRS has a Voluntary Classification Settlement Program (VCSP), which operates as an amnesty program for employers who want to reclassify previously misclassified workers. Many employees who have been incorrectly classified as independent contractors by their employers can file Form 8919, Uncollected Social Security and Medicare Tax on Wages, to figure and report the employee's share of uncollected Social Security and Medicare taxes due on their compensation

Expect More to Come

Former IRS Commissioner Koskinen, who left the IRS this past November, recently underscored the importance of third-party information reporting in discussing the tax gap: “when there is information reporting, such as 1099s, income is only underreported about 7% of the time…but that number jumps to 63% for income not subject to any third-party reporting or withholding.” With that kind of return on investment, increasing levels of information reporting seem to be here to stay.

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

Compute Taxable Life Insurance Benefits

Life insurance proceeds are received tax-free. However, any interest earned on life insurance proceeds, usually referred to as its cash value, is subject to tax. Special rules apply to transfers of ownership in a life insurance policy, accelerated death benefits, and viatical settlements.

An insurance policyholder might purchase one of many different types of life insurance covering the life of the insured. Term insurance covers a certain period of time, most often one year. If the insured does not die during the term of coverage, no policy proceeds are paid and the policy lapses. Other types of policies, including ordinary life insurance, whole life insurance, variable life insurance, and universal life insurance, provide insurance (and, often, an investment component) during the insured's life span. Regardless of the type of policy, the beneficiary pays no tax on the proceeds when the insured dies. However, sometimes, usually due to a delay in paying the policy proceeds, the life insurance company pays the beneficiary interest in addition to proceeds. Any interest paid by the life insurance company must be included in income. The exclusion from gross income applies only to the policy proceeds. If a policy owner surrenders a life insurance policy in exchange for its cash value, the amount received is not the result of the insured's death. Therefore, it is not tax-free and is considered ordinary income to the policyholder. Only the amounts paid by the policy owner, which are a return of capital, are not taxed. The remainder is subject to tax.

Traditionally, life insurance was intended to provide financial assistance to the insured's survivors. In some cases, however, terminally or chronically ill policyholders may sell the policy to meet their financial needs prior to death. When a policyholder sells the policy back to the insurance company for a percentage of its face value, the proceeds are called "accelerated death benefits." The policyholder might also sell the policy to a third party for a lump-sum payment. The proceeds are referred to as a "viatical settlement" and the third party is usually a viatical settlement company. The third party becomes the policyholder and beneficiary.

Accelerated death benefits and viatical settlement payments are not paid on account of the death of the insured. However, they may be excluded from income only if the person is diagnosed with a terminal illness (or a chronic illness, but only to cover long-term care expenses).

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IRS Requirements for Changing Accounting Method

The method and systems by which a taxpayer calculates the amount of income, gains, losses, deductions, and credits and determines when these items must be reported, constitute the taxpayer's method of tax accounting. Although the tax code and the regulations authorize the use of several accounting methods and permit certain combinations of methods, a taxpayer must use the accounting method he or she regularly uses to compute book income. Further, the method must be used consistently and must clearly reflect income.

A taxpayer's method of accounting includes not only the overall method of accounting, but also the accounting treatment of any item. The taxpayer may not treat a particular item in a manner that differs from the overall method.

After a taxpayer has adopted a particular method of accounting, either as an overall method of accounting or as a method of accounting for a particular material item, any changes in accounting method must first be approved by the IRS. The IRS may exercise its sole discretion in accepting a taxpayer's return as computed under the new method of accounting, unless the taxpayer has properly obtained its prior consent to the change.

A change in accounting method may be requested by a taxpayer or required by the IRS. The IRS usually must approve all changes in methods and may specify conditions for implementing the change. The IRS grants automatic consent to many accounting changes. Catch-up adjustments that prevent items of income and expenses from being omitted or reported twice, thereby avoiding possible post-change distortion of income, may be required.

The IRS has provided procedures for obtaining its consent to a change in accounting method. There are two types of consent—automatic consent and advance (non-automatic) consent. Both types of consent require taxpayers to file a Form 3115, Application for Change in Accounting Method. The advance consent procedures require payment of a user fee. The current IRS List of Automatic Changes is found in Revenue Procedure 2017-30.

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How Will California React to Tax Reform?

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California will not automatically conform to most of the federal changes in the tax reform. It will take California legislation to conform to most of the federal changes, and it is highly likely that we will not see full conformity.

Excluding rate reductions, it seems most of the individual changes will increase federal taxable income, while business changes will decrease net income. A pessimist may say California will conform to the individual changes, but not the business changes. The following are the most talked about changes that will create new adjustments on the California return.

Individual changes

Most of these changes will increase federal taxable income:

- Principal residence:
  - Reduction or elimination of property tax deduction;
  - Reduction of mortgage interest limit; and
  - Under the House bill, elimination of deduction for interest on a second home.
- Other Schedule A deductions eliminated:
  - Medical expenses (House version only);
  - Federal increase to 60% adjusted gross income for charitable contribution deduction;
  - Casualty losses not deductible (disaster losses still deductible); and
  - Miscellaneous itemized deductions, specifically tax preparation fees and unreimbursed employee business expenses.
- Moving expenses: not deductible, other than for military personnel.

Business and investment changes

There are some of the major changes that will impact our business clients:

- Internal Revenue Code (IRC) Section 1031 exchange treatment only available for exchange of real property: While California would still allow IRC Section 1031 treatment, this change would effectively eliminate exchange of nonreal property, such as artwork and tangible personal property;
- Increase bonus depreciation to 100% (California does not allow bonus depreciation);
- Disallow entertainment expenses except for meals;
- No longer allows transportation fringe or commuting benefit deductions;
- Limits net operating loss to 90%.

WHAT WILL THE CALIFORNIA FRANCHISE TAX BOARD (FTB) DO?

Absent conformity, California taxpayers will be more likely to itemize deductions for California than for federal purposes, and the federal Schedule A will have major changes. FTB may create their own Schedule A and certainly Publication 1001, Supplemental Guidelines to California Adjustments, will be pages longer.

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CALIFORNIA 2018 STATE DISABILITY INSURANCE RATE ANNOUNCED

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The California Employment Development Department has released the 2018 State Disability Insurance (SDI) withholding rate. The rate for 2018 is 1.0% and the taxable wage limit is $114,967 for each employee per calendar year. The maximum to withhold for each employee is $1,149.67.

In 2017, the rate was 0.9% and the taxable wage limit was $110,902, with a maximum to withhold of $998.12.

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Business and Other Standard Mileage Rates Increase in 2018

The IRS released the 2018 optional standard mileage rates that taxpayers and tax professionals can use to calculate the deductible costs of operating an automobile for business, charitable, medical, or moving purposes.

Beginning on January 1, 2018, the standard mileage rates for the use of a car (also vans, pickups or panel trucks) will be:

- 54.5¢ for every mile of business travel driven, up 1¢ from the rate for 2017;
- 18¢ per mile driven for medical or moving purposes, up 1¢ from the rate for 2017; and
- 14¢ per mile driven in service of charitable organizations.

The IRS noted that the business mileage rate and medical and moving expense rates have each increased 1¢ per mile from the rates for this year. The charitable rate, however, is set by statute and stays unchanged. The standard mileage rate for business comes from an annual study of the fixed and variable costs of operating an automobile, while the rate for medical and moving purposes is based on the variable costs. The IRS noted that taxpayers also have the option of figuring the actual costs of using a vehicle instead of relying on the standard mileage rate.

However, taxpayers cannot use the business standard mileage rate for a vehicle after using any depreciation method under the Modified Accelerated Cost Recovery System or after they claim a depreciation deduction under Internal Revenue Code Section 179 for that vehicle. On top of that, the business standard mileage rate cannot be used for more than four vehicles used simultaneously. The IRS describes those and other requirements in Revenue Procedure 2010-51.

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