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Welcome to Edition 7 of The Newsletter from Scott H. Novak, Attorney at Law. The Newsletter is designed to bring timely and interesting topics to accountants and attorneys. Comments and suggestions are always welcome. Feel free to call or write at any time.

IRS Substitute for Return Program

The IRS has many tools at its disposal for those "gotcha" moments. One such tool is a Substitute for Return (SFR). If a taxpayer does not file an income tax return, but the IRS was sent information about the taxpayer (W-2, 1099, 1098), the IRS has a basis for creating a tax return for that individual. Now, this is where their sense of humor comes out in an otherwise seemingly humorless agency. They take every bit of gross income that came in on reports, ignore any deductions and tax it at the highest rate. Then they assess the tax. So now a return and a tax liability have been created. And what is the statute of limitations on the tax liability created by this return? Is it the usual 10 year statute for collections? That's a trick question. Because the taxpayer did not file a return, there is NO statute of limitations.

How does a taxpayer change this unfortunate result? File a true tax return asap. It will take the IRS a while, but they will eventually use the return that you sent in as the actual return. And filing that return starts the tolling of the 10 year statute of limitations on collection. The real purpose behind the SFR program is to force the taxpayer to get their returns in to the IRS. So what is new that makes this program any more noteworthy right now than at any other time? This program is mostly automated at the IRS. The IRS has recently announced through a report from the Treasury Inspector General for Tax Administration that this program will be significantly cut back due to budget constraints.

Its use had already been scaled back. For example, from June, 2010 through July, 2011, the program brought in $3 billion. But for the period from June, 2015 through July, 2016, the program only brought in $430 million. We are in an era where Congress has made tremendous cuts to IRS funding. The results of these cuts can be seen throughout the Agency and in lower audit rates. Collections and criminal cases are down. But does it make sense to continue to cut the IRS budget? According to the IRS, it costs them 35 cents for every $100 of tax revenue that they bring in. If accurate, that is an incredible ROI. Maybe the folks in Washington who control the IRS budget know something that we don't know.

IRS Criminal Investigation Division 2016 Annual Report

More news on the IRS budget cut front. From 2013 to 2016, criminal investigations that the IRS initiated dropped 36%, from 5,314 to 3,395. The number of criminal investigation (CI) agents has dropped by 13% over the same period. The high water mark for the number of CI agents was 1995, when the Service employed 3,363.

Now there are 2,217. What kind of cases did CI focus on in 2016? Here are the Investigative Priorities:

1. Abusive Return Preparer Fraud
2. Abusive Tax Scheme Fraud
3. Employment Tax Fraud
4. Fraud Referral Program
5. Identity Theft Fraud
6. International Tax Fraud
7. Political/Public Corruption
8. Questionable Refund Fraud

Under the category of General Tax Fraud, the Report states that general tax fraud investigations directly influence the public's tax compliance and are the backbone of CI's enforcement program. Certain schemes were identified in the report:

1. Skimming by deliberately underreporting or omitting income
2. Maintaining dual sets of books
3. Creating false entries in books and records
4. Claiming personal expenses as business expenses
5. The use of false deductions or credits to decrease taxes
6. Hidden or transferred assets for the purpose of avoiding the payment of taxes

Tax Reform and Tax Cuts for the Middle Class

With tax reform on the horizon, much is heard about tax cuts for the middle class and higher taxes for the wealthy. As with most political debates, one can find compelling arguments for opposing positions. The Tax Policy Institute estimates that under the Republican tax blueprint, the median family would see a reduction in taxes of $420, while the top quintile would see a reduction of about $10,610. Quite appalling when no other facts are considered. Here are some other facts to consider. According to a report on 2013 income tax burdens (the latest year for which such information is available) put out by the Congressional Budget Office (CBO), the highest-earning 20% of taxpayers paid 88% of all federal income taxes, or about $1.2 trillion. The next 20% paid $175 billion, while the bottom 60% collectively paid $0. This does not include employment taxes, which arguably impact lower income earners more than higher income earners. When all federal taxes are considered, the top 20% carries 69% of the burden, while the middle quintile pays about 8.9% of the burden. Another interesting statistic is that the top 1% pays 38% of all income taxes, while only earning 15% of all pre-tax income.

Tax reform is generally about income taxation. It is very difficult to show that any tax reform is meant to favor the middle class when the top 20% pays such a large share of the federal income tax burden. The bottom three quintiles carry such a low proportion of the tax burden, zero percent in many cases and a refund due to the Earned Income Tax Credit in many others, that mathematically, any proportional cut will impact the top 20% more than the middle class. The aggregate tax savings will generally align with the aggregate tax burden. It would be easy to argue for a reduction in taxes that cover Social Security and Medicaid, because reductions here would have a true positive impact on the bottom three quintiles. But these programs are heavily relied on by this group of people in later years. For an interesting editorial on the topic of tax reform, see Reidl, *Yes, U.S. Tax Cuts Will Mainly Benefit Those Who ... Pay the Most Taxes*, New York Post, October 6, 2017.

Staying on the topic of tax reform, it is a hard task indeed. Want to simplify the Code? Eliminate deductions and lower the tax rate. But some of the deductions that theoretically could be eliminated are very popular. Eliminating them could be political suicide. Look at SALT, for example - the state and local tax deduction. Along with the mortgage interest deduction and charitable contributions, this is one of the largest deductions offered to individuals. The Tax Policy Center estimates that the deduction will cost the federal government $96 billion in 2017. This is a deduction that favors wealthier families and individuals. 30% of all Americans took this deduction, with about half going to those with annual incomes over $200,000. Who specifically would the elimination of SALT impact? The tristate area and California have some of the highest property taxes in the country. You would see more of an impact in those states than in most others. Other ideas that have been floated - elimination of the current income exclusion for 401(k)s and the making employer-provided health insurance taxable. Perennial favorites where a major change in tax policy could impact entire industries. Another one? Tax more of the Social Security benefits people receive. The fact that the FICA tax is paid with after-tax dollars seems not to matter. Stay tuned - Congress is gearing up for quite the fight.

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