TAXOLUTIONS

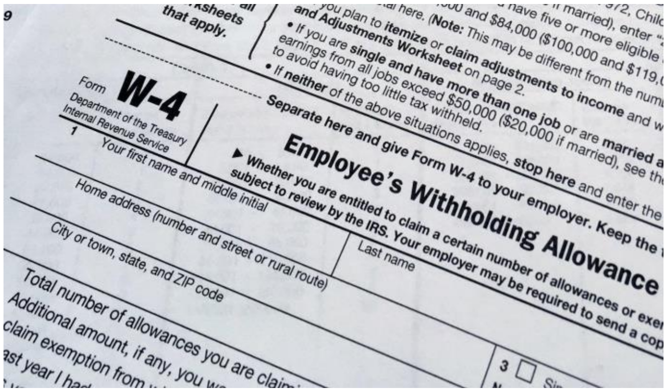
IRS Recommends Taxpayers Adjust Withholding

Noting that taxpayers who have previously itemized may be affected by changes from the Tax Cuts and Jobs Act (TCJA), the IRS issued a reminder on May 16 encouraging individuals who have in the past itemized their deductions on Schedule A of Form 1040 to use the IRS's Withholding Calculator in 2018 to perform a "paycheck checkup" to make sure their employer is withholding the appropriate amount of tax from their paychecks given their financial situation.

The IRS pointed out that the TCJA nearly doubled standard deductions and changed or eliminated several itemized deductions, and that these changes will affect 2018 tax returns. Among the tax law changes that go into effect in 2018 are limits on the deductions for state and local taxes to $10,000 ($5,000 if married filing separately); limits on the deduction for home mortgage interest; and exclusions on deductions for employee business expenses, investment expenses, and tax preparation fees.

In light of these changes, the IRS said, individuals who formerly itemized may now find it more beneficial to take the standard deduction, which could in turn affect the amounts taxpayers should instruct their employer to withhold from their paychecks. The agency advised employees to use the results from the Withholding Calculator to help determine if they need to complete a new Form W-4; and, if so, what information they should put on a new Form W-4.

The IRS also recommended that even those taxpayers who expect to continue to itemize deductions check their withholding to reflect the changes introduced by the TCJA. When using the Withholding Calculator, taxpayers are asked to indicate whether they are taking the standard deduction or itemizing their deductions. If they are itemizing, they are prompted to enter estimates of their deductions. The Withholding Calculator then applies the relevant provisions of the TCJA to these amounts when calculating the user's withholding.



In addition, the IRS urged taxpayers to complete their paycheck checkup as early as possible so that if a withholding amount adjustment is necessary, they have more time for the withholding to take place evenly throughout the year, and can thus avoid an unexpected tax bill or penalty at tax time in 2019. The agency therefore urged employees who need to complete a new Form W-4 to submit it to their employer as soon as possible.

The IRS also pointed out that adjusting withholding after a paycheck checkup can prevent employees from having too much tax withheld. “With the average refund topping $2,800, some taxpayers might prefer to have less tax withheld up front and receive more in their paychecks,” the agency observed.

The agency further suggested that taxpayers refer to their completed 2017 tax return when using the Withholding Calculator, as the information on the return can help them estimate the amount of income, deductions, adjustments and credits to enter; as well as their most recent pay stubs, as this information can help the calculator compute the employee’s withholding so far this year.

The IRS also reminded taxpayers that if they experience a change in personal circumstances that reduces their number of withholding allowances, they are required to submit to their employer a new Form W-4 with corrected withholding allowances within 10 days of the change. The agency cautioned that the calculator results depend on the accuracy of information entered. “If a taxpayer’s personal circumstances change during the year, they should return to the calculator to check whether their withholding should be changed,” the IRS advised.

The agency emphasized that the Withholding Calculator does not request personally identifiable information, such as name, Social Security number, address, or bank account numbers; and that the IRS does not save or record the information entered on the calculator. Moreover, the IRS does not send emails related to the Withholding Calculator or the information entered. “As always, taxpayers should watch out for tax scams, especially via email or phone and be alert to cybercriminals impersonating the IRS,” the agency said.

In other announcements, the IRS specifically encouraged taxpayers with more complex tax profiles to visit the Withholding Calculator and perform a paycheck checkup. The agency recommended that taxpayers who work seasonal jobs or are employed part of the year conduct such a check-up, as any changes that a part-year employee makes to their withholding can have an even greater impact on each of their paychecks than changes made by employees who work year-round.

In addition, the IRS urged two-income families and taxpayers who work multiple jobs to complete a paycheck checkup to verify they are having the right amount of tax withheld from their paychecks. “The IRS Withholding Calculator can help them navigate the complexities of multiple employer tax situations and determine the correct amount of tax for each of their employers to withhold,” the agency said.

Bipartisan Effort to Reform the IRS

In a rare bipartisan initiative, Congress is considering a package of reform bills aimed at modernizing and improving the information technology, infrastructure, and services of the IRS under the heading of the Taxpayer First Act. The proposed reforms represent the first major effort by Congress to overhaul the IRS in 20 years, since the passage of the Internal Revenue Service Restructuring and Reform Act of 1998.

The package of bills mandates major structural reforms and service improvements for the IRS. Among other reforms, the Taxpayer First bills would establish an independent appeals process, revise enforcement procedures, develop a comprehensive customer service strategy, change the Commissioner’s name to Administrator of the Internal Revenue Service, and create a new position known as the IRS Chief Information Officer (CIO). The reform package passed the full House on April 17 and 18 with near-unanimous support, and the Senate is expected to consider the legislation later in the summer of 2018.

The most significant of the bills approved by the House were the 21st Century IRS Act (H.R. 5445) and the Taxpayer First Act (H.R. 5444). Under the proposed legislation, the IRS would be required to place more taxpayer services online and develop secure online portals for taxpayers and their preparers to improve the agency's ability to assist taxpayers with their filings, while also reinforcing its efforts to combat identity theft and fraud.

Among the most important provisions in the legislation is a new requirement for the IRS to submit a customer service strategy to Congress. The components of this proposed strategy include the adoption of best practices from the private sector, such as providing online services and telephone call-back services. The legislation also calls for an assessment of whether certain IRS services could be co-located with other Federal offices or offered for self-service, and the introduction of plans to update guidance and training materials for IRS customer service employees, as well as metrics for measuring progress. In addition, the legislation directs the IRS to maintain the IRS Free File Program, which provides low-income taxpayers with free tax return preparation services.

The Treasury Department would be required under the proposed legislation to develop online accounts for taxpayers and preparers by 2024, which taxpayers could then use to upload information and make payments. The reform package further mandates that the Treasury develop a process for accepting tax forms electronically, and create an online service for taxpayers to prepare and file 1099 forms. The IRS would then be allowed to directly accept credit and debit card tax payments. The fees for the use of credit, debit, or charge cards for tax payments would be recouped by charging taxpayers.

In addition, Treasury would be required to establish a program for issuing identity protection personal identification numbers (IP PIN) upon a taxpayer's request in order to deter identity thieves from filing a taxpayer's income tax return. The legislation would also require the IRS to provide identity theft victims with a single point of contact at the agency.

Moreover, the proposed legislation would codify the CIO role at the IRS. The CIO is expected to oversee the development and ongoing security of the agency's IT, and would be required to develop a multiyear strategic plan for the agency's IT needs. The legislation would also codify the IRS Office of Appeals in order to streamline the appeals process, and to provide fair and impartial determinations for concerns raised by taxpayers.

To better protect taxpayers, the legislation would seek to ensure that the IRS sends notice to the actual taxpayer when conducting an audit before contacting friends, neighbors, and clients; and would restructure IRS enforcement tools to ensure that taxpayers do not have their assets seized without proper, timely, and fair notice. While the legislation would not eliminate the agency's controversial private debt collection program, which allows the IRS to use private companies to collect unpaid taxes, it includes provisions to protect taxpayers from harassment and abuse by debt collectors.

The Senate Finance Committee is currently reviewing the House bills and is expected to craft its own IRS reform package over the summer, using these bills as a starting point.

Following the passage of the reform package in the House, the House Ways and Means Committee commented in an announcement that these bipartisan bills are the result of nearly a dozen hearings and roundtables, countless briefings and meetings, and close work with stakeholders over the course of the last two years.

House Oversight Subcommittee Chairman Lynn Jenkins (R-KS) observed that “as a CPA, I’ve seen first-hand countless examples of the IRS being out of date with technology and out of touch with the needs of the taxpayer.”

“At a time when Americans are increasingly frustrated by government and the apparent inability to get things done for the country, these bills are a welcome reminder that there are issues that unite both sides of the aisle and we can get things done that improve the lives of every American,” Jenkins said. “The taxpayer deserves a better experience with the IRS and this bipartisan effort will seek to accomplish exactly that.”

Deductibility of State and Local Taxes Post-TCJA

In response to actions by states to create “workarounds” to expand the limits on the state and local tax deduction imposed by the Tax Cuts and Jobs Act (TCJA), the Treasury Department and the IRS issued on May 23 Notice 2018-54, which indicated that proposed regulations will be issued that address the deductibility of state and local tax payments for Federal income tax purposes. The notice was also intended to make clear to taxpayers that Federal law controls the characterization of such payments for Federal income tax purposes, regardless of how the payments are characterized under state law.

The TCJA limited the amount of state and local taxes (SALT) an individual can deduct in a calendar year to \$10,000, or to \$5,000 if married filing separately. This limitation applies to taxable years beginning after December 31, 2017, and before January 1, 2026.

In response to this new limitation, some state legislatures are considering or have already adopted legislative proposals allowing taxpayers to make payments to funds controlled by state or local governments, or other transferees specified by the state, in exchange for credits against the state or local taxes the taxpayer owes. In the notice, the IRS said it recognizes that states are passing legislation aimed at allowing taxpayers to make transfers that are characterized as fully deductible charitable contributions for Federal income tax purposes, while using the same transfers to satisfy state or local tax liabilities.

In recent months, the legislatures of states with relatively high state and local taxes—such as New York, New Jersey, California, Illinois, and Connecticut—have either passed or proposed laws aimed at preserving the SALT tax deduction in the form of a payroll tax deduction; or that offer taxpayers the option of contributing to one or more state charitable funds to satisfy their state and local tax liabilities.

As charitable contribution deductions were not limited under the TCJA, these deductions are effectively designed to get around the new limitation on SALT deductions for individuals.

In New Jersey, for example, legislation was recently passed that permits local and county governments, as well as school districts, to establish local charitable funds. Taxpayers would then be permitted to take a credit on their New Jersey property tax bill of up to 90% of any contribution. Similarly, in New York, local governments and school districts are allowed to create charitable funds and offer donors a property tax credit. New York has also created a state charitable gifts trust fund, which permits taxpayers to make contributions for health care or education in return for a state tax credit of up to 85% of any contribution. In addition, New York recently passed a law allowing employers to expand payroll taxes as an option for taxpayers who want the extra deduction. Some states, including New York, are even weighing suing the Federal government for discriminating against high-tax states.

The IRS warned, however, that taxpayers should be aware that the IRS and Treasury are continuing to monitor these and other legislative proposals that are being considered to ensure that Federal law controls the characterization of deductions for Federal income tax filings. The notice advised that, despite these state efforts to circumvent the new statutory limitation on state and local tax deductions, "taxpayers should be mindful that Federal law controls the proper characterization of payments for Federal income tax purposes."

The notice further asserted that the Treasury and the IRS intend to propose regulations addressing the Federal income tax treatment of transfers to funds controlled by state and local governments or other state-specified transferees that the transferor can treat in whole or in part as satisfying state and local tax obligations. In addition, the notice asserted that the proposed regulations will make clear that the requirements of the Internal Revenue Code, informed by substance-over-form principles, govern the Federal income tax treatment of such transfers, thereby suggesting that these transfers will not be treated as charitable contributions under Federal law.

"The upcoming proposed regulations, to be issued in the near future, will help taxpayers understand the relationship between Federal charitable contribution deductions and the new statutory limitation on the deduction of state and local taxes," the notice said.

House Ways and Means Committee Chairman Kevin Brady (R-TX) praised the move by the IRS and Treasury to restrict efforts to circumvent the limits on the SALT deduction. "Our new pro-growth tax code is putting more money into the pockets of workers and families nationwide," Brady said. "It's unfortunate that some politicians are still trying to discredit this new economic momentum in defense of high taxes and stagnant growth."

However, Governor Phil Murphy of New Jersey, a Democrat, said he was confident the state's charitable deduction legislation was legal. Observing that the Federal government's policy on charitable deductions has become inconsistent, Murphy warned that efforts to block such deductions could open it to challenges in court. "For the Federal government to permit certain states to allow for charitable deductions, but not others that are following the same principles, is unconscionable," Murphy said. "I remain committed to fighting the SALT deduction tax cap and am confident that the solution signed into law can and should be embraced by the IRS."

Guidance on the Business Interest Deduction

In April 2, the IRS and the Treasury Department issued interim guidance in Notice 2018-28 for calculating the business interest expense limitation in Section 163(j) of the Internal Revenue Code, as amended by the Tax Cuts and Jobs Act (TCJA).

The TCJA included a number of provisions that reduced the tax burden of businesses, including a corporate tax rate cut from 35% to 21% and a new 20% deduction on qualified business income. To offset a portion of the cost of the tax cuts, the TCJA imposed limits on the amount of interest certain businesses can deduct under Section 163(j). The new limitation, which is generally effective starting in 2018, applies to all taxpayers, except certain trades or businesses and taxpayers whose gross receipts do not exceed $25 million.

Before 2018, taxpayers could generally deduct business interest, subject to a few relatively uncommon exceptions. Under changes made to Section 163(j) by the TCJA, the deduction for business interest is limited to the sum of

(1) the taxpayer's business interest income;
(2) 30% of the taxpayer's adjusted taxable income for the tax year; and
(3) the taxpayer's floor plan financing interest for the tax year.

The IRS announced that it intends to release proposed regulations, and identified certain issues the proposed regulations will address, including the application of Section 163(j) at the level of consolidated groups, the impact of Section 163(j) on earnings and profits, and the treatment of a C corporation's interest income and expense as business interest income or expense. The notice also clarifies that partnerships and S corporation shareholders cannot interpret the amended Section 163(j) to inappropriately "double count" their business interest income. In addition, the IRS stated that future regulations will clarify that taxpayers with disallowed business interest are permitted to carry forward this interest to the succeeding tax year.

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