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# Tax Topics

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### And the beat goes on…

Last fall's 16-day government shutdown ended with legislation that President Obama signed in the wee hours of October 17th. Under that legislation, a bipartisan committee hammered out a budget agreement by mid-December; Congress approved the agreement, and President Obama signed it into law. House and Senate appropriations committees then began drafting spending bills – on which they compromised: H.R. 3547, the "Consolidated Appropriations Act, 2014," passed both the House and the Senate with comfortable bipartisan majorities; it became Public Law 113-76 on January 17th, when President Obama signed it. The Act allocates $1.012 trillion, is over 1500 pages long and funds the government through September 30, 2014 (the end of the current 2014 fiscal year).

The Act restored some of the funding cuts otherwise dictated by the "sequester," which was born of budget legislation (and the debt ceiling crisis) in August 2011. It covers discretionary spending for all government agencies, and has nothing to do with mandatory spending, such as Social Security. In other words, for example, the Act covers national defense, commerce, the judiciary and what are referred to as "financial services," which includes the IRS. Although overall appropriations are up slightly for financial services from last year's enacted level, the $11.289 billion appropriated for the IRS is about 4% less than last year, and continues a downward trend in IRS funding.

Under the Act, the IRS will have new quarterly reporting requirements with respect to some of its spending, and must abide by some pointed directives, including maintaining training programs to cover items such as "taxpayers' rights, dealing courteously with taxpayers, cross-cultural relations, ethics and the impartial application of tax law." An additional $92 million is potentially available to the IRS to supplement certain areas of its budget, but not until the IRS Commissioner first provides a spending plan for those dollars, none of which can be used to support any provision of the Affordable Care Act (ACA, which is also known as "Obamacare"). The IRS also cannot make a video unless it is pre-approved by the Service-Wide Video Editorial Board, nor can the Service use any of its funds to target citizens who are exercising their First Amendment rights or to target groups for "regulatory scrutiny based on their ideological beliefs."

In other words, the budget takes note of recent issues that have reflected poorly on the IRS, including the Service's enhanced scrutiny of politically conservative groups that were seeking tax-exempt status as 501(c)(4) social welfare organizations, and the disclosure of certain training videos that spoofed several old television shows and were deemed wasteful. John Koskinen, the new IRS Commissioner, has many challenges ahead of him, including restoring public confidence in the agency and boosting employee morale.

## National Taxpayer Advocate

Nina Olson has been the National Taxpayer Advocate since 2001. She heads up the Taxpayer Advocate Service (TAS), which was created in 2000, and is an independent organization within the IRS. Ms. Olson and the TAS are the taxpayer's "voice at the IRS." The TAS is designed to help taxpayers navigate issues with the IRS when the usual channels have failed; in addition, Ms. Olson regularly focuses on larger issues within the IRS and the tax system itself, and recommends solutions. Her year-end Annual Reports to Congress are thorough and thoughtful, and in part, detail what she views as the most serious issues facing taxpayers.

Ms. Olson's 2013 Annual Report was released on January 9, 2014, and, as always, is interesting reading. One of the critical issues Ms. Olson focuses on in this report is that the IRS "desperately" needs more funding to serve taxpayers and increase voluntary compliance. Ms. Olson presents some compelling statistics to support this statement. In fiscal year 2013, for example:

- The IRS received about 109 million phone calls; only 61% of the callers seeking a customer service representative got through, and those who did had to wait an average of 18 minutes before speaking with someone.
- The IRS received about 8.4 million letters from taxpayers responding to proposed adjustments to their tax accounts; it was unable to respond to 53% of this correspondence within its target timeframes.
- The IRS continues to reduce (and sometimes eliminate) services at its nearly 400 walk-in sites; the Service will only answer "basic" tax law questions during this current filing season (January through April), and will not answer any of those questions beyond April.

Ms. Olson also notes that since fiscal year 2010, the IRS workforce has declined about 8%, and that its training budget has been "slashed" from about $172 million to about $22 million, a "staggering" 87% reduction. "Thus," she says, "the IRS not only has fewer employees than four years ago, but those who remain are less equipped to perform their jobs."

Ms. Olson calls the recent IRS budget cuts "shortsighted and counterproductive" for several reasons: 1) our system relies on voluntary compliance, and the harder it is for taxpayers to get answers, the less likely they are to comply; 2) the IRS is a money-maker: in fiscal year 2013, it collected roughly 90% of federal revenue – or about $2.86 trillion on an appropriated budget of about $11.2 billion (an average return on investment of 255:1); of those revenues collected, some 98% were paid timely and voluntarily, with only 2% coming from enforcement actions. "In fiscal terms, to be blunt, the mission of the IRS trumps the missions of all other federal agencies."

At his confirmation hearing last December, IRS Commissioner John Koskinen voiced similar sentiments:

> I don't know any organization in my 20 years of experience in the private sector that has said "I think I'll take my revenue operation and starve it for funds to see how it does." The IRS will have 11,000 fewer people working during this upcoming filing season while processing the largest number of returns in its history. I don't care how efficient you become, that is not a recipe for success or improved compliance and taxpayer service.

**In a nutshell…**Tax collectors are never popular. Yet if the IRS lacks sufficient funds to do its job properly, that means fewer dollars all around for all federal programs, including national defense, Social Security and Medicare – *and* for reducing the deficit. Perhaps, as Ms. Olson suggests, Congress should change the way it approaches the IRS's budget and fund the IRS at whatever level Congress believes will "maximize tax compliance, particularly voluntary compliance, with due regard for protecting taxpayer rights and minimizing taxpayer burden."

## Changes afoot in New York?

On January 21, 2014, New York's Gov. Andrew Cuomo (D) introduced his comprehensive Executive Budget for New York's 2014-2015 fiscal year. The budget has a number of tax reform proposals, including "modernizing" New York's estate tax law and closing what it refers to as the resident trust "loophole." Here are a few highlights of this draft legislation:

- **Estate Tax.** For decedents dying on or after April 1, 2014, New York would begin lowering its top estate tax rate of 16% (this currently applies to taxable estates just over $10 million), and increasing its $1 million estate tax exclusion amount; by April 1, 2017, the top estate tax rate would have dropped to 10%, and the exclusion amount would have reached $5.25 million. As of January 1, 2019, that exclusion amount would be indexed for inflation using the "cost of living adjustment," defined as the percentage by which the consumer price index (CPI) for 2018 exceeds the CPI for 2012; as of January 1, 2020, the cost of living adjustment would be the percentage by which the CPI for 2019 exceeds the 2018 CPI; in 2021, the adjustment would be the percentage by which the 2020 CPI exceeds the 2018 CPI, and so forth, in subsequent years. In addition, as of April 1, 2014, resident New York decedents would have to include "adjusted taxable gifts" (see below) made on or after that date in their New York *gross* estates if they were New York residents when they made the gifts; non-resident New York decedents would not include such gifts in their New York *taxable* estates unless the gifts were of real or tangible property located in New York, or of intangible property used in a New York trade or business.

  **Comments.** The memorandum in support of this legislation states that New York's estate tax is "woefully out of date," and that it gives wealthy New Yorkers an incentive to leave the state. In part, the legislation would address this problem by lowering New York's estate tax rate, and eventually raising its estate tax exclusion to the federal basic exclusion amount, which it cites as $5.25 million, indexed for inflation. Indeed, thanks to inflation-indexing, the basic exclusion amount was $5.25 million in 2013, and in 2014, it is $5.34 million – meaning that in 2014, a married couple can protect up to $10.68 million from federal gift or estate tax, assuming they haven't made any prior gifts that used up some of this exclusion (these are the "adjusted taxable gifts" referred to above). Thus, New York's draft legislation targets a number ($5.25 million) that is already stale. Nevertheless, the legislation would start indexing the New York exclusion for inflation as of 2019; presumably, its CPI references would successfully match New York's exclusion to whatever the federal exclusion then is.

  In addition, including certain lifetime gifts made on or after April 1, 2014 in the New York estate tax computation could definitely increase a decedent's New York estate tax, which generally doesn't reflect those gifts. It goes without saying that a New Yorker currently contemplating a significant lifetime gift might want to complete that gift prior to April 1, 2014, given this draft legislation. But New Yorkers who haven't yet made such gifts might be reluctant to do so – they may not want to, and may not even be a New York resident at death.

- **The resident trust "loophole."** The memorandum in support of this legislation explains that it would make two "improvements" to the taxation of trusts. First, it would tax distributions of trust income accumulated in prior years ("accumulation distributions") to New York beneficiaries of non-resident trusts (generally, trusts created by someone who was not a New Yorker) and of tax-exempt resident trusts (generally, trusts created by a New Yorker that are exempt from New York income tax because they have no New York trustees, no property located in New York, and no New York-source income). Second, the bill would eliminate a "loophole" that allows so-called incomplete gift, non-grantor trusts ("INGs" or "DINGs," if the trusts are created in Delaware) to completely avoid New York income tax; it would do so by making the trust a "grantor trust" for New York income tax purposes – meaning that the creator of the trust would be taxable on the trust's income for New York purposes, even though the creator is not taxable on that income for federal purposes. Although these proposals would be retroactive to January 1, 2014 if enacted, some transition rules would apply: accumulation distributions paid before June 1, 2014 would be exempt, and the ING rules would not apply to income from a trust that is liquidated before June 1, 2014.

**Comments.** This proposed legislation reflects recommendations from the Trusts and Estates section of the New York Bar Association that were included in the November 2013 report from the Tax Reform and Fairness Commission. According to the bill's supporting memorandum, the provisions would increase tax revenues by $75 million in fiscal year 2014-15, $225 million in fiscal year 2015-16, and $150 million annually thereafter. In other words, these proposals are perceived as money-makers. Yet whether that would indeed be the case remains to be seen: wealthy New Yorkers seem unlikely to view these changes as "improvements" to the taxation of trusts, but rather, as another reason to move out of New York.

## January and February 7520 rates issued

The IRS has issued the January and February 2014 applicable federal rates: the January 7520 rate is 2.2%, an increase of 0.20% (20 basis points) from December's 2.0% rate. January's mid-term rates are also up slightly, and are: 1.75% (annual), 1.74% (semiannual and quarterly), and 1.73% (monthly). February's 7520 rate continues to climb: it is 2.4%, and the February mid-term rates are also up: 1.97% (annual), 1.96% (semiannual and quarterly) and 1.95% (monthly). December's mid-term rates were: 1.65% (annual), 1.64% (semiannual and quarterly), and 1.63% (monthly).

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