Pilla Talks Taxes

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HOW THE IRS WILL LEVERAGE ITS MASSIVE INFORMATION

Big Data Meets Big Government

One of the reasons that identify theft is considered by the Treasury Inspector General for Tax Administration to be the crime of the century—and why I maintain that it cannot be stopped—is because of the IRS. The IRS makes more and more demands for more and more information about more and more aspects of people's businesses and private lives every day. There is no such thing as personal privacy these days. That the IRS sends citizens a so-called "Privacy Act Notice" in every one of its mailings is a farce. The IRS lays more of a claim to more of your data without court authority than any other government agency. And to make matters worse, they share the data with any other federal, state or local government agency claiming an interest, including foreign governments.

A River of Data

This year alone, there will be about 152 million individual tax returns filed with the IRS. There will be roughly another 100 million business tax returns filed. There will be millions more miscellaneous tax returns, including trust, estate and gift tax returns. And on top of that, over 3.6 BILLION information returns (Forms W-2, 1099, etc.) will be filed with the IRS over the next couple of weeks. There is quite literally a river of data flowing into the agency every year. The flow cannot be stopped, and what's worse, as far as the IRS is concerned, they need even more data.

For example, one of the six "Strategic Goals" presented in the IRS's 2018-2022 Strategic Plan is to increase its access to data, and use that data more effectively to drive its agency-wide decision making, as well as case evaluations and selections for enforcement purposes. See: IRS Publication 3744 (4-2018). This is consistent with the previous five-year plan, which presented the overarching goal of becoming a "data driven agency."

Indeed, the IRS is awash in data. The 2018-2022 Strategic Plan boasts that the IRS's volume of data was 100 times larger in 2017 than it was ten years prior. In 2018, the IRS Criminal Investigation unit alone collected 1.67 petabytes of data from various sources. A petabyte

In this issue

"Dan Pilla probably knows more about the IRS than the commissioner of the IRS." Associated Press.

is 1,099,511,627,776 bytes, or 1,024 gigabytes of data. I'm told that approximately 900,000 plain text files can fit into a single gigabyte. The number of users in the IRS with access to that data has increased 23 times (Strategic Plan, pg 19) in the past ten years.

Managing Massive Data

How do you manage, process and assimilate such a massive amount of data to the point where it becomes usable? The 2018-2022 Strategic Plan expresses the goal to "invest in analytics and visualization software and tools, and develop processes to support analytics in IRS operations" (Strategic Plan, pg 20). The end game is presented in these words:

> Advancements in how data is collected, stored, accessed and analyzed will allow us to deploy data better. We'll standardize our data processes and protocols and encourage collaboration among all IRS business units. Increased interoperability of data systems and sources will enhance the secure and seamless flow of data to enable greater authorized access to information. We'll invest in training to develop more advanced analytics skill sets across the IRS, and use data to improve our business processes. Strategic Plan, pg 19.

The investment in analytics was recently undertaken—in a big way.

Big Government, Meet Big Data

On September 27, 2018, the IRS entered into a contract with Palantir Technologies of Palo Alto, CA, to handle the task of data assimilation. The contract calls for Palantir to provide hardware, software and training to IRS employees to "capture, curate, store, search, share, transfer, perform deconfliction, analyze and visualize large amounts of disparate structured and unstructured data." IRS Contract Proposal, Performance Work Statement, January 11, 2017, pg 1.

Palantir is to build and train the IRS to use a unified supercomputer to:

> search, analyze, visualize, and interact with a wide variety of disparate data sets so users will be able to leverage the platform to perform advanced analytics, such as link, pattern, statistical, behavioral, and geospatial analysis on an investigative platform that is scalable and interoperable with existing IRS equipment and systems. Ibid, pg 2.

What kind of data are we talking about? The contract proposal specifies the following data formats:

- Oracle, MySQL, and PostgreSQL databases;
- Delimited files (.csv, .dsv, .log, or .txt);
- Excel files (.xls, .xlsx);
- GraphML files (.graphml, .xml);
- IVML files;
- Email files (.eml, .pst, .mbox, .msg, .ost, .txt); and
- PCAP files (.pca, .pcap, .pcp). Ibid, pg 20.

Ingesting Massive Amounts of Data

The contract proposal goes on to state exactly what the IRS is looking for. The need is for an "analytical platform with a strong storage and indexing power allowing for rapid integration and analysis of ultra-large scale data sources." Ibid, pg 2. Specifically, the system must meet the following criteria:

- Allow for the rapid ingestion of massive amounts of data.
- Users should be able to immediately use the imported data in the imported format to perform queries, analysis and identify links.
- Allow users to drill down on massive amounts of disparate data to find connections.
- Provide algorithms and capabilities that identify the key players and their roles for the user.
- Allow users to visualize connections from millions of records with thousands of links by grouping data visualization by the commonalities and roles. Ibid, pg 20.

This system is intended to allow the IRS to meaningfully link tens of millions of tax returns, billions of information returns, and trillions of bank and credit card transactions, phone records, and even social media posts. For example, if a U.S. citizen moves money from a Swiss bank to some other offshore bank, then uses credit or debit cards to spend the money in the U.S., Palantir's software can link those transactions. It could also flag a person whose tax return shows relatively low annual income but whose social medial posts indicate something entirely different. A 2015 IRS privacy report reveals that since 2013, Palantir has had access to personal information including passport numbers, text messages, criminal histories, and mothers' maiden names. Case Lead Analysis, PIA ID No. 1120, July 28, 2015.

This is exactly the kind of data analysis it will take to establish the IRS's so-called "up-front tax system," which I describe at length in chapter 2 of *How to Win Your*

Tax Audit. Under that system, the taxpayer is essentially removed from the tax preparation process because the IRS knows everything there is to know about your personal, business and financial affairs to the point where they prepare the return for you. How's that for tax simplification?

The Cost of Spying

Since 2004, Palantir provided the federal government with various software platforms for the CIA, the Department of Justice, and the Department of Defense. All of it is related directly to enhancing the government's data analysis capabilities.

The IRS began working with Palantir in 2013. The agency spent $30.8 million on a five-year contract, and at that time granted Palantir access to files for more than 1 million people, according to a July 28, 2015 audit report. That contract provides the IRS with access to spy software for use by Special Agents (criminal investigators) "to generate leads, identify schemes, uncover tax fraud, and conduct money laundering and forfeiture investigative activities." Case Lead Analysis, PIA ID No. 1120, July 28, 2015, pg 4.

As far as the IRS's September 2018 deal is concerned, the federal government will pay Palantir $98,750,546.94 over seven years to fulfill the contract. My question is, why the extra 94 cents?

New IRS Commissioner is on Board

The new IRS Commissioner is Charles Rettig. He took office on October 1, 2018. In November, at a meeting of the Council for Electronic Revenue Communication Advancement (imagine how exciting that conference must be), he said, "The equipment at the IRS needs to be brought into the 21st century." He said the IRS will focus efforts on building the agency's technical infrastructure on an ongoing basis.

Rettig also made a statement that appears to indicate he is willing to choose technology over people when it comes to the agency's resources. Where technology and staffing are concerned, he said, "we may have to make some choices" depending on the funding package provided by Congress. He went on to say, "We're working for the long game, and we'll sacrifice the short game to get there."

If the IRS's $99 million spy software works as promised, the agency will simply not need thousands of people to wade through the morass of data it's collecting every year.

More "Eggshell Audits"?

"Eggshell audit" is the phrase we use to describe a situation in which counsel knows going into an audit that there are, let's say, "problems" with a taxpayer's records and the claims on a tax return. For example, I once spoke with a man many years ago who was selected for audit in connection with his rental property income and expenses. He had about fourteen rental properties and claimed a substantial deduction for real estate taxes. He said he was being audited and was concerned about the real estate tax deduction because he had no records.

"That's no problem," I said. "We can easily reconstruct the expenses. We can go to the county and just get their records." Then he repeated what he already told me, that he didn't have the records.

"I realize that," I said. "We'll have to reconstruct them."

"You don't understand," he replied. "There are no records because I just made up the numbers."

I paused for a moment, and then said, "Oh. That's different."

And that, my friends, is an eggshell audit.

How does counsel handle such a situation so that the audit is resolved without the case leading to a referral for criminal investigation and potential prosecution? That task is quite a challenge, and the "how" part depends upon a great many factors, not the least of which is full knowledge by counsel of exactly what he's getting into before stepping on any land mines.

But what happens when neither counsel nor the client necessarily knows what the land mines are? For example, will the client know that his Facebook or Twitter posts alerted the IRS to the fact that he might be underreporting income? There is no way to know this going in. As a result, counsel must be extra vigilant to gather facts from a client before discussing anything with the IRS. The facts must be carefully mined through detailed discussion with the client, a thorough review of the current tax return, an analysis of prior returns, and by reviewing all the client's documents.

Counsel should also consider making Freedom of Information Act Requests to ascertain as much as possible from the IRS regarding the facts already present in the file. There is simply no substitute for having all

the information to the extent available. In chapter 3 of my book, *Taxpayers' Defense Manual*, I discuss the Freedom of Information Act at length, and illustrate how to make an FOIA Request.

WHAT YOU NEED TO KNOW ABOUT DEDUCTIONS FOR 2018

The Tax Cuts and Jobs Act Affects Itemized Deductions

The Tax Cuts and Jobs Act will affect how individual citizens claim deductions. This article recaps some of the very basic things to keep in mind as tax filing season approaches.

First, remember that the standard deduction amounts are nearly double for 2018 compared to what they were 2017. The amounts break down as follows:

Joint returns and surviving spouses	**$24,000**
Heads of Household	**$18,000**
Singles	**$12,000**
Married filing separately	**$12,000**

Citizens who have reached the age of 65 during the tax year or are legally blind get an additional standard deduction. The additional standard deduction amounts are as follows:

Joint returns and surviving spouses	**$1,300**
Heads of Household	**$1,600**
Singles	**$1,600**
Married filing separately	**$1,600**

Because of the substantial increase in the standard deductions, many people who formerly itemized deductions will likely be better served by claiming the standard deduction. Thus, the much talked about limitations to itemized deductions will have very little impact on most filers. For example, about 70% of all returns filed prior to the Jobs Act didn't claim itemized deduction in the first place. For all those people, the near doubling of the standard deduction will mean great tax savings, even if there were no changes to their financial lives whatsoever. This fact alone should put to rest the bogus claim that the Jobs Act was nothing more than "tax cuts for the rich."

For those who continue to itemize, there are a few things to keep in mind as you organize your records for tax return filing.

1. The limit on overall itemized deductions is suspended. The income-based phase-out of certain itemized deductions does not apply in 2018. This means that some higher-income people will be able to deduct more of their total itemized deductions than in the past when their income was above certain levels.

2. Deductions for state and local taxes are limited. The deduction available for state and local income taxes, sales taxes and property taxes is limited to a combined, total deduction. The limit is $10,000 for married filing jointly, and $5,000 for single filers. Anything above the cap is not deductible. However, with the near doubling of the standard deduction, the limitation on state and local taxes may be moot for a great deal of people. It may be that most people will be better served with the higher standard deduction than they would be with a full deduction for state and local taxes.

3. Lower dollar limit on home residence loan balance. The date you acquired a mortgage or home equity loan on your main home may impact the amount of interest you can deduct. If your loan originated on or before December 15, 2017, you may deduct interest on up to $1 million of qualifying mortgage debt ($500,000 for married filing separately). If the loan originated after that date, you may only deduct interest on up to $750,000 in qualifying debt ($375,000 for married filing separately). The limits apply to the combined amount of loans used to buy, build or substantially improve your main home and a second home.

4. The deduction for home equity interest is modified. Interest paid on most home equity loans is not deductible unless the loan proceeds were used to buy, build or substantially improve a main home or second home. For example, interest on a home equity loan used to build an addition to an existing home is typically deductible. However, interest on a home equity loan used to pay personal living expenses, vacations, most vehicles, and credit card debts, is not. In any case, to be deductible, the loan must, a) be secured by your main home or a second home, b) not exceed the cost of the home, and c) meet certain other requirements.

5. The limit for charitable contributions is modified. The annual limit on the deduction for charitable

contributions of cash increased from 50% to 60% of one's adjusted gross income. This means that those who make large charitable donations can deduct more of what they gave in 2018.

6. The deduction for casualty and related losses is modified. Personal casualty losses must now be attributable to a federally declared disaster to be deductible.

7. Miscellaneous itemized deductions are suspended. Under prior law, people who itemized deductions could deduct miscellaneous itemized deductions that exceeded 2% of adjusted gross income. These expenses are no longer deductible. This includes unreimbursed employee expenses such as costs for uniforms, union dues and the deduction for worker-related meals, entertainment and travel. It also includes deductions for tax preparation fees and investment expenses, such as investment management fees and safe deposit box fees. However, do not confuse this with meal and travel expenses associated with businesses. Despite much confusion over the issue, business meals for self-employed people remain tax deductible. See my articles in both the June and July 2018 issues of *PTT*, and my additional discussion below.

Get More Help Now

With all the changes brought about by the Tax Cuts and Jobs Act, it is more important than ever to get counsel when preparing your tax return. Check with the Tax Freedom Institute member nearest you to get the help you need now. Go to: *www.taxhelponline.com*, and click on the Tax Freedom Institute logo in the lower left corner of the home page, or just follow this link: *https://www.taxhelponline.com/tax-help-now/ask-the-expert/tax-freedom-institute.html*

IRS ISSUES GUIDANCE ON BUSINESS MEALS

Meal Expenses for Businesses Remain Deductible

After the passage of the Tax Cuts and Jobs Act, there was much confusion over changes made to code §274(a). That is the provision that sets limits on the ability to deduct business entertainment expenses. The Jobs Act eliminated the deduction for business entertainment expenses. Many commentators believed that the demise of entertainment expenses also sounded the death knell for meal expenses. But that is not true. Because of the importance of this issue, I presented a session on this topic at the 2018 Taxpayer Defense Conference in October.

In my articles in the June and July issues of this newsletter, I proved that meal expenses remain deductible, regardless of the fact that Congress eliminated entertainment expenses. Not all meals constitute entertainment. Moreover, I proved that meal expenses were never controlled by code §274(a), which was the section repealed by the Jobs Act. Rather, meal expenses are controlled—and always have been controlled—by code §162. This was confirmed long ago by the Tax Court in *Russo v. Commissioner*, T.C. Memo. 1982-248 (1982).

Code §162 controls whether any particular expense constitutes a deductible business expense. Under §162, for any expense to be deductible, the expense must be:

1. "Ordinary and necessary" to the success of the business,

2. Incurred to produce income, and

3. Reasonable under the circumstances.

The June issue of *PTT* presents a very detailed analysis of code §162 as it applies specifically to meals. I give detailed examples, some directly from decisions of the U.S. Tax Court, to illustrate what a meal expense is versus an entertainment expense. I conclude that meals which are not entertainment expenses continue to be deductible.

The IRS agrees with me. On October 3, 2018, the IRS issued Notice 2018-76, to provide guidance definitively settling the dispute. The Notice follows my legal analysis of the issue, and in some places repeats nearly word-for-word what I said about the matter in my June article.

In the Notice, the IRS acknowledges that:

1. Meals are controlled by §162, not §274;

2. The Jobs Act repealed only "entertainment"

expenses under §274(a)(1) and did not touch §162;

3. The definition of "entertainment" was not changed by the Jobs Act;

4. Section 274(e) continues to allow a deduction for meals (see my July article for a full discussion of §274(e)); and

5. The legislative history of the Jobs Act clarifies that taxpayers may continue to deduct business meals. See: Notice 2018-76, citing H.R. Rep. No. 115-466 (2017) (Conf. Rep. on the Jobs Act).

The ultimate conclusion reached by Notice 2018-76 is that business meals continue to be deductible. The IRS set out five rules that must be met to deduct business meals. Meals are deductible if:

1. The expense is ordinary and necessary under §162(a);

2. It is not lavish or extravagant under the circumstances;

3. The taxpayer or an employee of the taxpayer is present during the meal;

4. The meal is provided to a current or potential customer, client, consultant, or similar business contact; and

5. In the case of meals provided during or at an entertainment activity, the meals are purchased separately from the entertainment, or the cost of the meal is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts. The entertainment disallowance rule may not be circumvented through inflating the amount charged for food and beverages. See: Notice 2018-76.

Point 5 above actually goes even further than the examples I gave in the June 2018 issue of *PTT*. Based on the analysis I presented, I concluded that if a meal was an integral part of an entertainment activity, such as taking a client to a baseball game, the cost of food and beverages purchased at the game would not be deductible. However, the IRS does not subscribe to that limitation. Point 5 above makes it clear that as long as the meals are purchased separately from the entertainment activity, they remain deductible as long as the other four elements are also met.

The examples presented in Notice 2018-76 bear this out. Keep in mind as you read on that these are the IRS's examples. These are not my examples based on my understanding of Notice 2018-76.

For purposes of each example, assume: 1) all meals meet the §162(a) rules, 2) they are not lavish or extravagant, and 3) the taxpayer and the business contact are not engaged in a trade or business that has any relation to the entertainment activity (i.e., a sports writer attending a football game expressly to write about the game).

EXAMPLE 1 – Taxpayer A invites B, a business contact, to a baseball game and buys the tickets. While at the game, A buys hot dogs and drinks. The baseball game is entertainment as defined in Treas. Reg. §1.274-2(b)(1)(i). Thus, the cost of the tickets is not deductible. The cost of the hot dogs and drinks, which are purchased separately, is not an entertainment expense and is deductible.

EXAMPLE 2 –Taxpayer C invites D, a business contact, to a basketball game. C purchases tickets to a suite, where they have access to food and beverages. The cost of the tickets, as stated on the invoice, includes the food and beverages. The game is entertainment as defined in Treas. Reg. §1.274-2(b)(1)(i). Thus, the cost of the tickets is an entertainment expense and is not deductible. The cost of the food and beverages, which are not purchased separately from the game tickets, is not stated separately on the invoice. Thus, the cost of the food and beverages also is an entertainment expense. C may not deduct any of the expenses associated with the basketball game.

EXAMPLE 3 – Assume the same facts as in Example 2, except that the invoice for the game tickets separately states the cost of the food and beverages. The cost of the tickets remains non-deductible. However, the cost of the food and beverages, which is stated separately on the invoice, is not an entertainment expense. C may deduct 50 percent of the food and beverage costs. [Editor's note: the deduction for business meals is limited to 50% of the total cost.]

Going forward, it will be essential (as usual) to keep proper records to support your meal expense claims. Code §274(d) requires detailed substantiation to support any meal (or entertainment for years prior to 2018) expense deduction. Per §274(d)(4), a taxpayer must have "adequate records or evidence corroborating taxpayer's own testimony" to show the following:

1. The amount of the expense,

2. The time and place of the travel, meal, entertainment, amusement, recreation,

3. The business purpose of the expense, and

4. The business relationship to the taxpayer of persons fed or entertained.

A detailed log or contemporaneous notes on receipts are essential to carrying this burden of proof. See my book, ***How to Win Your Tax Audit*** for more on this issue.

JOBS ACT GIVES SMALL BUSINESSES MORE WRITE-OFFS

Section 179 Deduction Was Expanded

Under §179 of the tax code, a business may elect to expense all or part of the cost of property that generally otherwise has to be depreciated. Under §179, the property can be deducted (up to certain limits) in the year the property is placed in service. Under the Tax Cuts and Jobs Act, the maximum deduction was increased from $500,000 to $1 million. It also increased the phase-out threshold from $2 million to $2.5 million.

These changes apply to property placed in service in tax years beginning after December 31, 2017. For most businesses, this means the 2018 return to be filed in 2019. Section 179 property includes business equipment and machinery, office equipment, livestock and, in certain cases, qualified real property. The Jobs Act also modified the definition of qualified real property to allow businesses to elect to include certain improvements made to nonresidential real property.

The 100% "bonus" depreciation deduction generally applies to depreciable business assets with a recovery period of 20 years or less. Machinery, equipment, computers, appliances and furniture generally qualify for this deduction. The law also allows expenses for certain film, television, and live theatrical productions, and used qualified property with certain restrictions. The deduction applies to business property acquired after September 27, 2017, and placed in service after September 27, 2017 but before January 1, 2023.

The instructions for Form 4562, Depreciation and Amortization, provide details. You can also refer to Publication 535, Business Expenses, and Publication 946, How to Depreciate Property. I also recommend you talk with the Tax Freedom Institute Member nearest you.

THE FRENCH GAS TAX MAY BLOW UP— IN OTHER COUNTRIES

Merrill Matthews, Ph.D.
Resident Scholar, Institute for Policy Innovation

The recent French demonstrations against President Emmanuel Macron's gasoline tax increase may have been the first such uprising, but it probably won't be the last—in France or elsewhere. Thousands of French working-class demonstrators took to the streets of Paris and other parts of the country to protest Macron's 25-cents per gallon gas tax increase, with more increases to follow. The revenue would supposedly be used to fight climate change.

The average price of gas in France is about $7 a gallon, according to the Associated Press, which adjusted for the European use of liters. That's $140 to fill up a 20-gallon tank in a country where the average income is about two-thirds that of America's.

Macron didn't care because he wants to be seen as a leader in the fight against climate change, regardless of how much that legacy costs the working class. But he was stunned by the size and determination of the spontaneous revolt. After insisting he wouldn't cave on the gas tax, he did, and is now promising even more concessions.

France may be the most disruptive, but it isn't the first populist pushback. Australia became the first country to repeal its tax on carbon emissions, where the government imposes a tax on each ton of carbon released into the atmosphere. Even though it was considered model legislation, the Aussies didn't want it and the Senate repealed it in 2014. Prime Minister Tony Abbot called the tax "a useless destructive tax which damaged jobs, which hurt families' cost of living and which didn't actually help the environment."

Closer to home, California raised the state's gasoline tax by 12 cents last year to 55.22 cents per gallon, the second highest in the country. Instead of rioting, Californians forced a statewide tax-repeal vote last month. The effort failed, with 45 percent voting to repeal, but then gasoline isn't $7 a gallon in California—yet.

But larger battles may be coming.

The federal gasoline tax of 18.4 cents per gallon hasn't been raised in 25 years and has lost 64 percent of its purchasing power. That's a prime target for an increase. In addition, certain members of Congress recently introduced a bipartisan tax on carbon emissions that would force fossil fuel-producing companies to pay $15 for each ton of carbon their products emit. The tax would rise by $10 per ton every subsequent year.

Imposing carbon taxes is not about ways to pay for needed government services. It's about trying to discourage the use of fossil fuels and funding a climate change agenda. The lesson from France is that working-class voters have a limit. Push people too far and we may see Paris-like riots in our own back yards.

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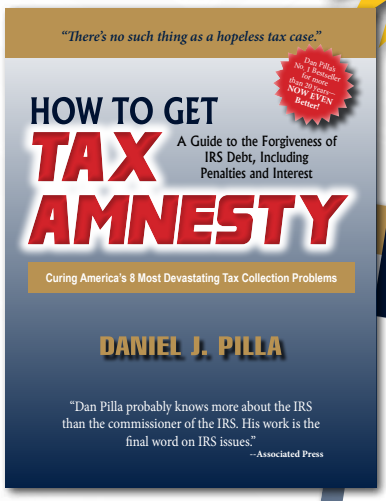

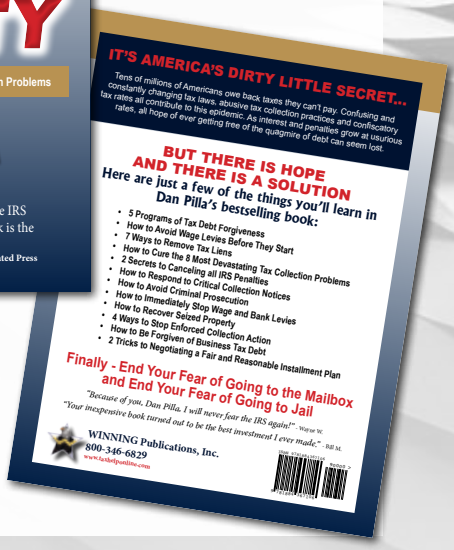

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