Lally&Co.
CPAs and Business Advisors

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Contact our office or visit our website for more information.

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Dear Clients and Friends,

Spring has arrived and with that came the end of another "busy" season. We would like to extend our sincere gratitude for the trust you have invested in us. Our clients and referral sources are the reason we had one of our busiest and most successful tax seasons. It would not have happened without each of you.

As you read through *The Evergreen*, please do not hesitate to contact us at any time. We would be happy to hear from you! This and past issues of *The Evergreen* are available on our website at http://lallycpas.com/newsletters/.

Deep Dive: US Government Expenditures

This is the third article in a series that attempts to explain in plain English certain past and current economic trends in the US budget. In the Fall 2014 edition of *The Evergreen,* we discussed our Federal government annual deficits (expenditures in excess of receipts) and debt (obligations of the Federal government to finance deficits and spending plans). In our Winter 2015 edition, we discussed our "deep dive" into our Federal government's receipts. In this edition, we are discussing Federal government spending. You can view past editions of *The Evergreen* at http://lallycpas.com/newsletters/.

A Quick Refresher
Historically, the Federal government spends more annually than it collects. In the 1960s, annual budgets resulted in net deficits which averaged 0.8% of total receipts; certainly a deficit but very close to breakeven years. In the 1970s, deficits increased to an average of 2.1% partially due to spending on the Vietnam War and the OPEC oil embargo. In the 1980s, deficits grew to 3.8% of receipts and, in the 1990s, deficits averaged 2.1%.

Those of you who remember the days of Presidents Nixon, Ford, Carter, and Reagan, there was plenty of ominous predictions regarding how Federal deficit spending was creating "huge" deficits. Oh, to be back in those days!

In the 2000s, deficits averaged 2.1% of receipts but that masks a decade of very different annual results. The first two years (2000 and 2001) had surpluses that averaged 1.8%, while the next six years (2002-2007) averaged deficits of 2.3%, and the last two years (2008 and 2009) had deficits that averaged 6.5%, which continued to today. The "Great Recession" (2008) resulted in average annual deficits of 7.6% over the 2009 to 2014 period.

The following chart tracks Federal receipts, outlays, and surpluses / deficits from 1940 through 2020 (estimated), all in constant 2009 dollars (billions).

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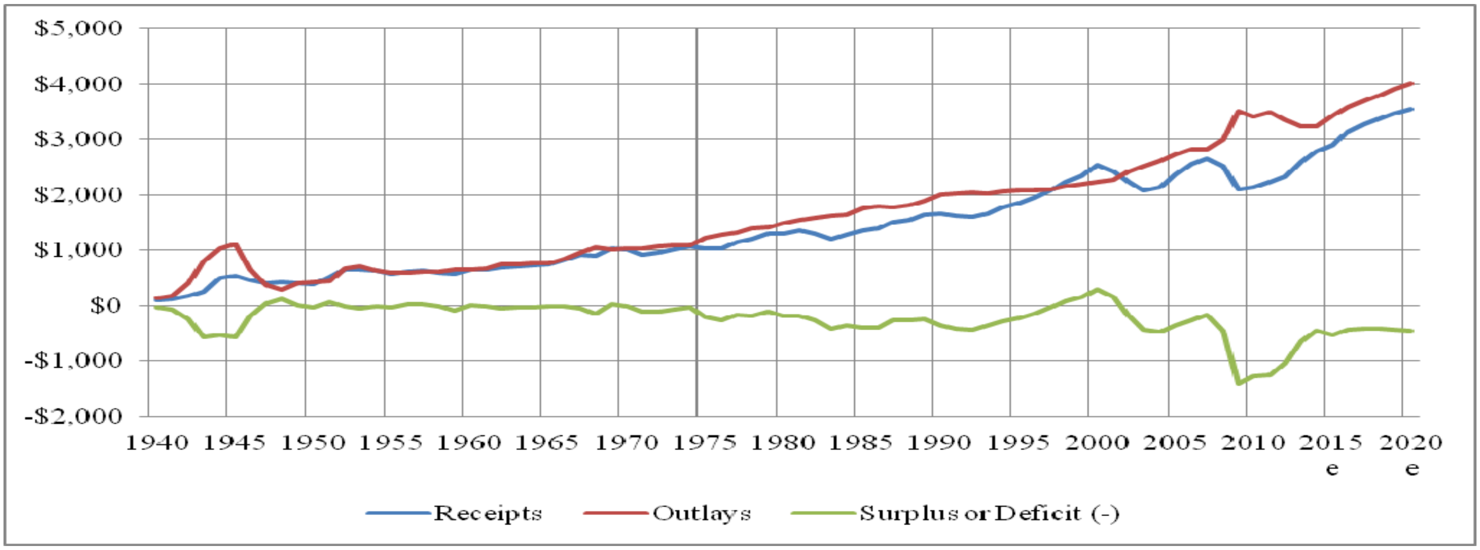
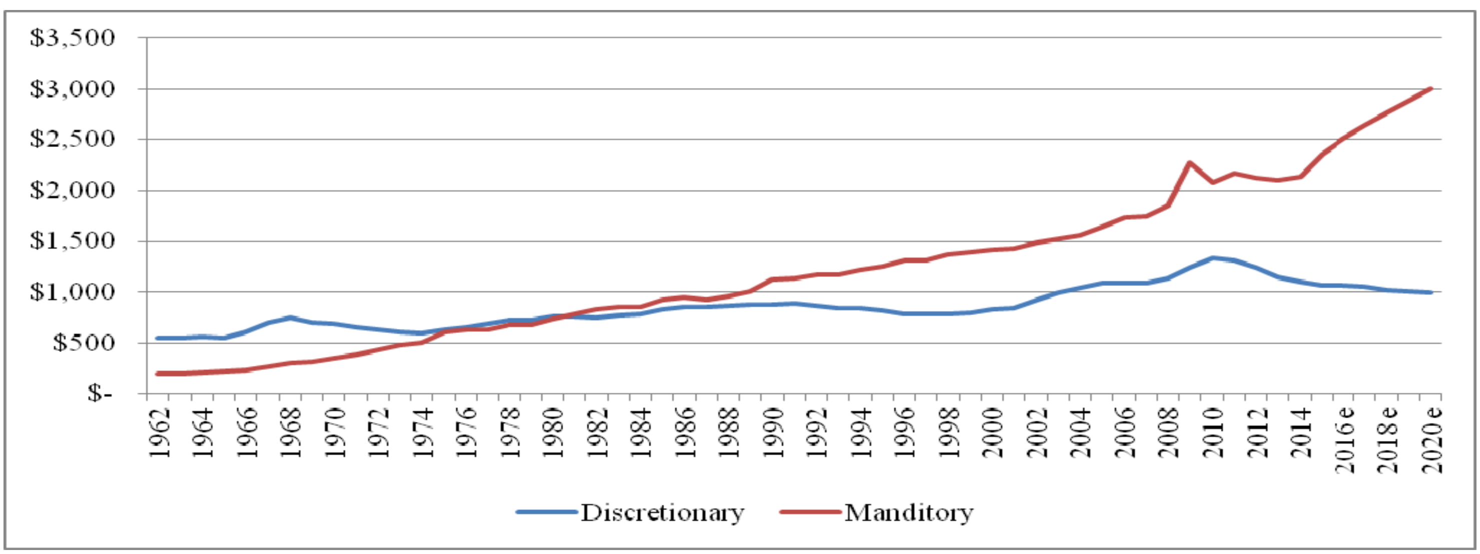


<u>What Makes up "Outlays"?</u>
Outlays can be divided into to broad categories:

- <u>Discretionary</u>: consisting of national defense, spending in cabinet departments (e.g. agriculture, justice, state, and transportation departments), science, space, and other technologies, and national resources and environment
- <u>Mandatory</u>: Medicare / Medicaid, income security (Federal employee retirement, unemployment compensation, food / nutrition assistance, earned income tax credit), social security, and net interest expense

The following chart tracks discretionary and mandatory Federal outlays from 1962 through 2020 (estimated), again in constant 2009 dollars (billions).



Prior to the 1980s, discretionary spending <u>exceeded</u> mandatory spending. However, since then the growth in mandatory spending has far outpaced the growth in discretionary spending. In 2014, the Federal government spending nearly $2 in mandatory spending for every $1 in discretionary spending. In other words, nearly 67% of annual spending is mandatory, making any future reduction of this spending that more difficult.

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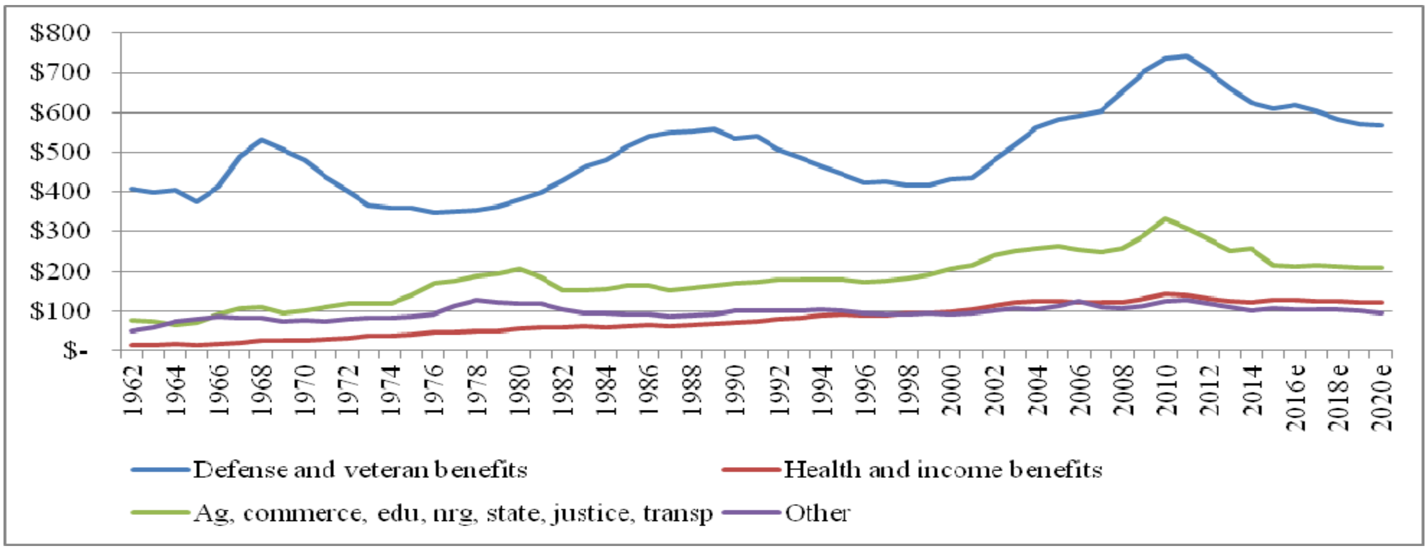
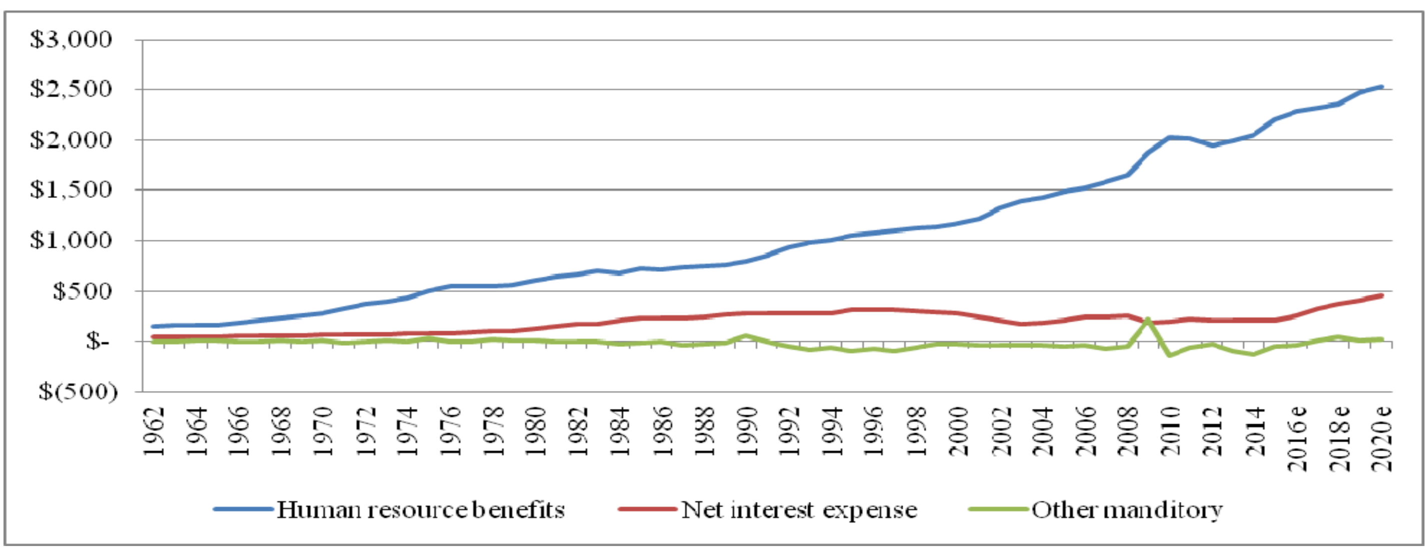
Discretionary Outlays

Over the 53-year period of actual budgets (1962 – 2014), discretionary outlays can be categorized into four groups: defense, benefits, cabinet offices, and other. Defense spending reflects the Vietnam era, Reagan's build-up in the 1980s, the effects of 9/11, and the Iraq and Afghanistan conflicts. Since the mid-1990s, defense spending has averaged 50% of discretionary spending and between 18% and 20% of all outlays. Health and income spending has expanded in recent years (2000 -2014), while departments of agriculture, commerce, education, energy, state, justice, transportation, and general government have been steadily expanding since the early 1970s. History has demonstrated that once spending increases, even in discretionary spending categories, it is rarely reduce but for defense spending on conflicts.



Mandatory Outlays

Over the 53-year period of actual budgets, mandatory outlays fall into two categories: human resource benefits and net interest expense on government debts. The primary driver to the growth in mandatory outlays is in the human resource benefits category.



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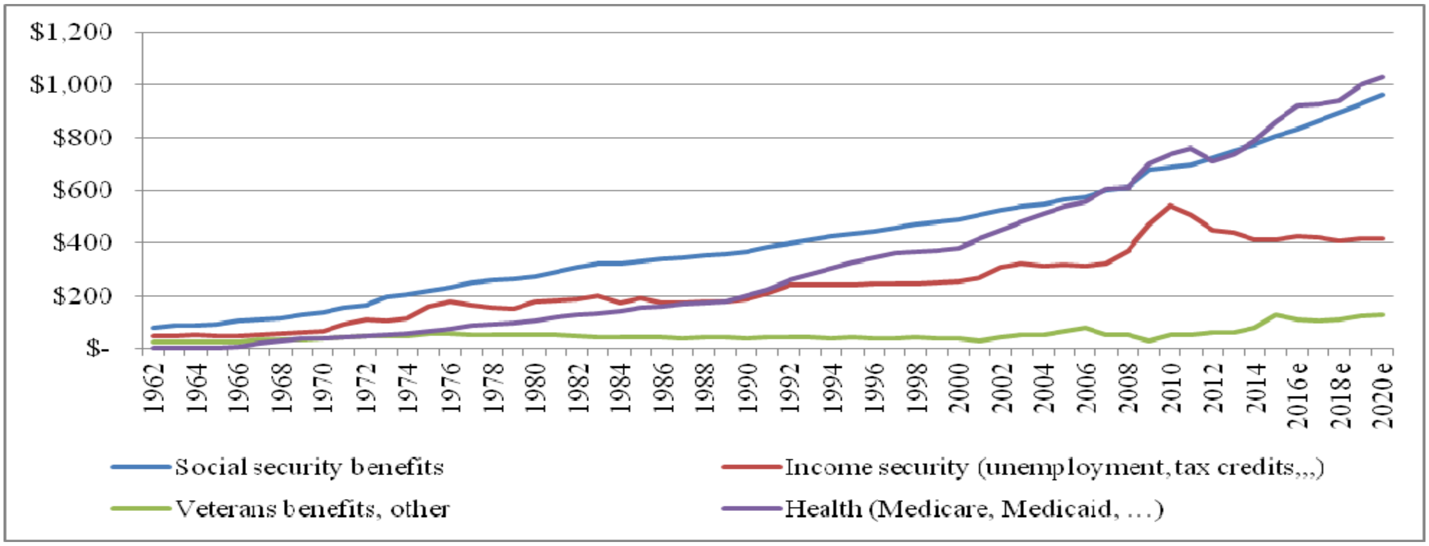
In 2014, the Federal government spent 12.4 times as much on human resource benefits than it did in 1962, all based on 2009 dollars and excluding any effects of inflation. Human resource benefits includes: social security benefits, income security benefits (e.g. unemployment benefits, earned income tax credits, other tax credits), health benefits (e.g. Medicare and Medicaid), and veterans' benefits.

In 2014, we spent 18.7 times as much on social security and health benefits than we did in 1962, again excluding any effects of inflation. In combination, social security and health benefits account for roughly 75% of mandatory spending and 48% of all outlays.



<u>Summary</u>

In our Winter edition of *The Evergreen*, we concluded that current annual deficits must be reduced with the hopes of generating annual surpluses in the next five years. The growth in outlays, especially mandatory outlays, must be collared for this to be achieved. So, when you hear that social security is the "third rail" of American politics, you can only imagine the number of potential voters that will be impacted by a cut in these or other health benefits. Unfortunately, politics will play a significant role in any reform. That does not change the facts that these outlays need to be slowed, with means testing, extending the normal retirement age, or through benefit reductions as alternatives being currently discussed. Or else large deficits are here to stay and our future economic picture remains cloudy and not as bright as the past 35 years.

Times a wastin'; In just the last quarter, our national debt increase by over $100,000,000,000 to $18.3 trillion. (http://www.usdebtclock.org/)

Are IRS audits one-size-fits-all?

In general, there are three types of IRS audits: correspondence audits, office audits, and field audits (listed in order of increasing invasiveness). Correspondence audits are initiated and generally conducted by postal mail. Office audits require a taxpayer and/or its representative to appear in an IRS office; and a field audit involves IRS examiners paying a visit to the taxpayer's place of business.

Correspondence audits

Correspondence audits, as the name suggests, are conducted entirely through the U.S. mail. (The IRS *never* uses e-mail to correspond with taxpayers.) Correspondence examinations require less involvement from IRS examiners and are therefore used more frequently by the budget-strapped IRS. Because correspondence examinations make up such a large percentage of the total examinations the IRS conducts, they are considered the "work horse" of the IRS audit tools. The IRS routinely uses correspondence examinations for issues that it generally deems more efficient and less burdensome to handle by mail, for example questionable claims for earned income tax credits (EITCs) or inconsistent line item

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Office audits
Generally, office examinations involve small businesses or individual income tax returns that predominantly include sole proprietorships. They involve issues that are too complex for a correspondence audit, which involves only the exchange of mail and (sometimes) a few telephone calls. Issues subject to an office audit, however, are usually not complex enough to warrant a full-scale field audit examination. Common issues include the substantiation of a business purpose, travel and entertainment expenses, Schedule C items, or certain itemized deductions.

In addition, if a taxpayer previously selected for a correspondence audit requests an interview to discuss the IRS's proposed adjustments, the case may be moved to the taxpayer's district office. Conversely, an examiner may sometimes determine that a tax return selected for an office audit examination would be better handled through a correspondence audit.

Office examinations generally take place at the IRS office located nearest to where the taxpayer maintains its financial books and records, which is generally its residence or place of business. However, on a case-by-case basis the IRS will consider written requests from taxpayers or their representatives to change the office examination location. A request by a taxpayer to transfer the place of an office examination will generally be granted if the current residence of the taxpayer or the location of the taxpayer's books, records, and source documents is closer to a different IRS office than the one originally designated for the examination. Additionally, Treasury Reg. 301.7605-1(e)(1) directs the IRS to consider several factors including whether the selected office audit location would cause undue inconvenience to the taxpayer.

Field audits
The IRS initiates a field exam audit usually by sending either a letter that lays out the issues to be examined and lists a specific IRS agent as the point of contact. Taxpayers must contact the revenue agent within 10 days of receiving the initial contact letter in order to schedule an interview. Generally an Information Document Request (IDR) also accompanies the initial contact letter and contains the IRS examiner's description of the audit-related documents it wants to review.

Conducting a field examination of a tax return requires the agent to have far greater knowledge of tax law and accounting principles than do correspondence or office audits, and therefore, field examiners are generally much more experienced than other examiners. Field audits almost always take place where the taxpayer's books, records, and other relevant data are maintained, which generally means the taxpayer's residence or place of business. However, if a business is so small that a field examination would essentially require the taxpayer to close the business or would unduly disrupt the operation of the business, the IRS examiner can conduct the field examination at the closest IRS office or at the office of the taxpayer's representative.

How Do I Change My Tax Withholding?

An employer must withhold income taxes from compensation paid to common-law employees (but not from compensation paid to independent contractors). The amount withheld from an employee's wages is determined in part by the number of withholding exemptions and allowances the employee claims. Note that although the Tax Code and regulations distinguish between "withholding exemptions" and "withholding allowances," the terms are interchangeable. The amount of reduction attributable to one withholding allowance is the same as that attributable to one withholding exemption. Form W-4 and most informal IRS publications refer to both as withholding allowances, probably to avoid confusion with the complete exemption from withholding for employees with no tax liability.

An employee may change the number of withholding exemptions and/or allowances she claims on Form W-4, Employee's Withholding Allowance Certificate. It is generally advisable for an employee to change his or her withholding so that it matches his or her projected federal tax liability as closely as possible. If an employer overwithholds through Form W-4 instructions, then the employee has essentially provided the IRS with an interest-free loan. If, on the other hand, the employer underwithholds, the employee could be liable for a large income tax bill at the end of the year, as well as interest and potential penalties.

How allowances affect withholding
For each exemption or allowance claimed, an amount equal to one personal exemption, prorated to the payroll period, is subtracted from the total amount of wages paid. This reduced amount, rather than the total wage amount, is subject to withholding. In other words, the personal exemption amount is $4,000 for 2015, meaning the prorated exemption amount for an employee receiving a biweekly paycheck is $153.85 ($4,000 divided by 26 paychecks per year) for 2015.

In addition, if an employee's expected income when offset by deductions and credits is low enough so that the employee will not have any income tax liability for the year, the employee may be able to claim a complete exemption from withholding.

Changing the amount withheld
Taxpayers may change the number of withholding allowances they claim based on their estimated and anticipated deductions, credits, and losses for the year. For example, an employee who anticipates claiming a large number of itemized deductions and tax credits may wish to claim additional withholding allowances if the current number of withholding exemptions he is currently claiming for the year is too low and would result in over withholding.

Withholding allowances are claimed on Form W-4, Employee's Withholding Allowance Certificate, with the withholding exemptions. An employer should have a Form W-4 on file for each employee. New employees generally must complete Form W-4 for their employer. Existing employees may update that Form W-4 at any time during the year, and should be encouraged to do so as early as possible in 2015 if they either owned significant taxes or received a large refund when filing their 2014 tax return. The IRS provides an IRS Withholding Calculator at www.irs.gov/individuals that can help individuals to determine how many withholding allowances to claim on their Forms-W-4. In the alternative, employees can use the worksheets and tables that accompany the Form W-4 to compute the appropriate number of allowances.

Employers should note that a Form W-4 remains in effect until an employee provides a new one. If an employee does update her Form W-4, the employer should not adjust withholding for pay periods before the effective date of the new form. If an employee provides the employer with a Form W-4 that replaces an existing Form W-4, the employer should begin to withhold in accordance with the new Form W-4 no later than the start of the first payroll period ending on or after the 30th day from the date on which the employer received the replacement Form W-4.

Firm Announcements

Lindsey Burchell, CPA, MBA is engaged to be married to Markus Buchanan on May 28, 2016

Drew Kretz, CPA became father to baby boy, Hunter Xavier Kretz, born October 24, 2014

Andrew Coleman, CPA joined our Audit Department in February 2015 as a Staff Accountant

Important Dates

June 16, 2015 – 2015 2nd Quarter Estimated Payments Due

June 30, 2015 – Form 114, Report of Foreign Bank and Financial Accounts Due