The Tax Times

Wisconsin Society of Enrolled Agents

May 2012

Current Events

Identity Theft Letters

IRS has started to issue letters (LTR 4883C) to taxpayers whom they suspect may have had their identity stolen. The letters state that the taxpayers return has been received, but that more information is needed to process the return accurately. Unlike other letters that have been issued in the past this one does not tell the taxpayer what information they need to send. Instead it requests that the taxpayer call the number listed at the beginning of the letter or to provide a phone number and the IRS would call them. Many clients that receive this are elderly and may have filed previously as a secondary taxpayer on a Married Filing Joint return. Usually they do not want to call the IRS and often don't understand what the IRS is looking for. Per conversation with an IRS agent taxpayers who have previously filed as a secondary taxpayer and now are filing as a primary taxpayer will be getting these letters. Keep this in mind for your clients. After calling the IRS regarding these clients generally you are required to mail in their information to the Identity Theft Department, which causes further delays in the processing of the clients return.

Upcoming Seminars

May 24th and 25th – Brookfield Suites and Convention Center, Brookfield, WI

Laurie Downs is speaking on Marital Property in Wisconsin and Julie Molek will be covering Cancelled Debt on Thursday.

Thursday, May 24th 3:00PM is also the Annual Member Meeting – Please attend!

This will be followed by the Board of Directors Meeting. The Annual Banquet and Auction will also be held Thursday starting with cocktails at 6pm with dinner at 7pm.

In error the seminar did not include a cost for an additional guest at the banquet. For those planning on bringing a spouse, friend, relative or significant other the cost is $25.00 per person. Please write it in on your registration form. My apologies for this inconvenience.

Inside this issue:

Please remember to bring and item for the Auction. All proceeds go towards speaker and event costs.

Friday, May 25th Robin Mueller will speak on Social Secuirty and Ethics. This seminar does count both for EA's, RTRP's and Insurance Licensing. Katie Jansen will be speaking on Forms 1099 and the classification of an Employee versus an Independent Contractor

September 20th and 21st – Joint MnSEA Seminar – Days Hotel and Conference Center, LaCrosse, WI

On Thursday, September 20th Beanna Whitlock will be presenting The Ugly 1040, Kids are the Dardnest Things and Ethics and Professional Conduct.

Friday, September 21st presenters include Amy King who will be covering IRS Audit Procedures and Don Wollershiem and Linda Ferwerda speaking on Schedule C and E.

Welcome New and Returning Members

We would like to officially welcome new and returning members! The following people have either just joined or renewed their membership with WSEA. If you see them at an upcoming seminar, please make them feel welcome!

Kurt Barkei of the Armed Forces Stationed Abroad

Elizabeth Corbisier of Appleton

Charles Eichner of Racine

Dexter Schassberger of Waukesha

WSEA To Sponsor Former Working Together Seminars, Don Wollersheim, EA

After considerable negotiating with the Internal Revenue Service Liaison Office and the Wisconsin Department of Revenue, WSEA has been given the opportunity to host the Fall Tax Update seminars with cooperation of the Internal Revenue Service and the Wisconsin Department of Revenue.

Negotiations began when we were able to show that the new education requirements would be detrimental to the update seminars in the format in which they were conducted in the past.

With their assistance, we were able to devise a format that would give a full eight hours of continuing education credits of the required fifteen hours. The new format will include three hours of tax updates, two hours of ethics and three hours of federal tax law issues.

In keeping with their desire to serve the professional tax industry, the cost was held to a minimum to encourage a larger attendance - $60.00. The new endeavor is being run under the name Tax Updates for Tax Professionals.

We reviewed surveys from the last sessions and incorporated most of the suggestions into the new format. Larger venues are being provided to accommodate the demand. All venues will have classroom seating or round table seating to accommodate the request for tables. Attendees will be provided printed handouts of the materials to be covered.

You are among the first to receive notice that registrations are now open. Go to our new website at www.taxupdates4taxpros.com to do an online registration with the availability for credit card payment. The website gives a full listing of dates, locations, a chance to contact us with questions and a place for you to request an e-mail or phone response to you. You can call us at 920-629-1544.

We are very proud that the Wisconsin Society of Enrolled Agents has been given the opportunity to assist in this project.

Tax Updates for Tax Professionals

By Professionals for Professionals

Dave's Corner – EAs and the New Repair Regs., David J. Fayram, EA

Return preparer penalties have been increased several times over the last decade. The penalty at IRC section 6694 for understatement of a taxpayer's liability was last increased from $250 to $1,000 in 2007. Furthermore, IRS management is putting pressure on revenue agents to consider preparer penalties in every examination. Unless the position was disclosed or if it was with respect to a tax shelter, our only escapes from the penalty are that we had "reasonable cause" for the position, or that there was "substantial authority" for the position.[1]

At the time we are working on the return, the only thing we have much control over is to attempt to attain "substantial authority" for all our positions (especially important since this is the standard for undisclosed positions). While the term is used several times in the statutes, there is no definition provided by the statutes.

One is initially hopeful that the IRS has defined this term by issuing regulations. One is even more hopeful upon finding a reference to the term in the table of contents to the regulations issued under IRC section 6694[2] at Regulations section 1.6694-2(c). Unfortunately, such optimism is not rewarded when one finds a single word at the indicated paragraph: "[Reserved]." The IRS must be somewhat embarrassed about this because it issued a Notice in 2009 providing a definition.[3]

Despite these risks, we must get on with our business. We cannot look at every position on every return to determine if it meets this test, which the author takes to be a subjective test. We do have an obligation to learn what the law is and we should be reluctant to prepare returns with issues where we have not studied the law.

"The IRS has recently changed the law regarding depreciation in rather significant and surprising ways."

History

The IRS has recently changed the law regarding depreciation in rather significant and surprising ways.[4] These changes occupy about 72 pages in the Internal Revenue Bulletin. Most of the changes are not of concern unless you make decisions for large businesses as to what expenses must be capitalized, but there is one topic of interest to EAs: repairs to real estate. The deductions here could be significant on individual and small business returns. These regulations are the third set of proposed regulations issued over the past eight years. This set was also issued as temporary regulations, which increases their authority. They were issued on December 27, 2011 and, for the most part, are effective as of January 1, 2012.

If you do not know the new rules and prepare a return after they are in place, you will not have to worry about the definition of "substantial authority" because there will be *no* authority for the old rules. Your defenses to the penalty will be reduced to "reasonable cause" — an embarrassing and weak position.

The history goes back to the adoption of the Accelerated Cost Recovery System (ACRS) in 1981. Prior to 1981, buildings could be broken up into components (for example, doors, walls, windows, roofs, plumbing components, electrical service components, heating system, and cooling system).[5] Each component could be depreciated over its own life and it could be disposed of for a loss separately. The legislative history is clear that Congress intended to eliminate both the depreciation of building components over multiple recovery periods and claiming losses on disposition of the

components prior to the disposition of the entire building.[6] This was not controversial because the recovery period for buildings under ACRS was 15 years. Unfortunately, Congress steadily increased the recovery period for buildings until it reached 39 years in 1993.

"What if you took the undisclosed position that the remaining basis of the component should be deducted because it was abandoned?"

The problem should be well-known to us. For example, if a building component had a twelve-year life, the owner would start depreciating it over 39 years. At the end of twelve years, the component would be replaced. The replacement would be depreciated over a new 39-year period while still depreciating the original component. The same thing would happen at 24 and 36 years leaving four components on the depreciation schedule even though three of them were abandoned long ago. This happened with air conditioners, roofs, furnaces, etc.

Problems with IRS position

What if you took the undisclosed position that the remaining basis of the component should be deducted because it was abandoned? Would you have had substantial authority for the position under IRC section 6694? Since 1981, the IRS has pointed to the legislative history and insisted that you did not. In its view, you would have owed the $250/$1,000 penalty.

How might you have defended yourself against such a penalty? You might have started by noticing that legislative history is not very high on the authority chart. In fact, it is near the bottom. After IRC section 168 was adopted, the IRS included the rule in proposed regulations under section 168. When the Modified Accelerated Cost Recovery System (MACRS) was adopted in 1986, the prohibition was again mentioned in the legislative history. Proposed regulations are not much more authoritative than legislative history. If you had continued on to look at the statute (the very highest level of authority) you would have found no mention of early dispositions at all. The only statutory requirement is that the life and method of the component must be the same as the life and method of the building.[7] In short, the IRS has, for almost 30 years, taken a position unsupported by the statute. Oh, well.

Dave's Corner – EAs and the New Repair Regs., David J. Fayram, EA

In reviewing the authorities for the new regulations, the IRS has apparently determined that losses on early dispositions are not prohibited for MACRS property. [8]

Application of new regulations

Let's say you are preparing a 2012 return where the owner of a building put on a new roof. You know that the new roof must be capitalized with a 39-year life, but you would like to deduct the remaining basis in the abandoned roof. Your client has no records to show the cost of the old roof because he bought the building only a few years ago. The regulations recognize this problem and provide that, if the taxpayer cannot determine the unadjusted depreciable basis from its books and records, the taxpayer may use any reasonable method that is consistently applied to determine the basis. Obviously this situation will provide incentives to determine the cost of components when buildings are purchased.

There is a fine point here. You can't both deduct the cost of the old component because it is abandoned and deduct the cost of the new component as a repair. In some situations you might prefer the repairs deduction to the abandonment deduction. (New rules concerning the difference between repairs and capital improvements are discussed at great length in the new regulations and are summarized below.) You can provide more flexibility in this situation by electing to account for MACRS property using general asset accounts. The rules for general asset accounts have been changed and should be reviewed in the event you have clients who own buildings. Actually, there appear to be few reasons not to elect general asset accounts. Failing to make the proper election could cause problems, not with the IRS, but with the client.

Building components defined

We have come full circle from the prohibition on building components in 1981. In a seeming reversal, the regulations now require that new capitalization standards apply to building components and not to the building as a whole.[9] These components are defined as follows:

1. Building structure (walls, roof, floors, foundation, etc.)
2. Heating, ventilation, and air conditioning systems (motors compressors, boilers, furnace, chillers, pipes, ducts, radiators).
3. Plumbing systems (pipes, drains, valves, sinks, bathtubs, toilets, water and sanitary sewer collection equipment, and site utility equipment used to distribute water and waste to and from the property line and between buildings).
4. Electrical systems (wiring, outlets, junction boxes, lighting fixtures and associated connectors, and site utility equipment used to distribute electricity from the property line to and between buildings).
5. Escalators.
6. Elevators.
7. Fire-protection and alarm systems (sensing devices, computer controls, sprinkler heads, sprinkler mains, associated piping and plumbing, pumps, visual and audible alarms, alarm control panels, heat and smoke detection devices, fire escapes, fire doors, emergency exit lighting and signage, and fire-fighting equipment such as extinguishers and hoses).

8. Security systems for protection of the building and its occupants (window and door locks, security cameras, recorders, monitors, motion detectors, security lighting, alarm systems, entry and access systems, related junction boxes, associated wiring and conduits).
9. Gas distribution systems (pipes and equipment used to distribute gas to and from the property line and between buildings).
10. Other structural components identified in published guidance.

Although not in quotes, these categories are the ones defined at Regulations section 1.263(a)-3T(e)(2)(ii). These categories are not elective. Tax return preparers should be familiar with these components as it will be hard to keep track of building depreciation without them. Furthermore, there might be work for EAs who want to provide those who purchase buildings with a breakdown of the purchase price.

Repairs versus capital improvements

The last part of the puzzle is how to determine if a project resulted in a repair or a capital improvement. The regulations adopt a three-part improvement test. These three parts are also called the "capitalization standards." Here is a brief description of the three tests.

Betterments

A betterment results if the project meets any of the following:

1. Ameliorates a material condition of defect that existed prior to the taxpayer's acquisition of the unit of property or arose during the production of the unit of property;
2. Results in a material addition to the unit of property; or
3. Results in a material increase in capacity, productivity, efficiency, strength, or quality, or output of the unit of property.

For a building, the amount must be capitalized if it results in a betterment of the appropriate component.

Restoration

There are six possibilities here:

1. Replacement of a component of a unit of property and the taxpayer has properly deducted a loss for that component (other than casualty loss);
2. Replacement of a component of a unit of property and the taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss resulting from sale or exchange of the component;
3. Repair of damage to a unit of property for which the taxpayer has properly taken a basis adjustment as a result of a casualty loss or relating to a casualty event;
4. Returns the unit of property to its ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use;

5. Results in the rebuilding of the unit of property to a like-new condition after the end of its class life; or
6. Replacement of a part or combination of parts that comprise a major component or a substantial structural part of a unit of property.

Once again, the "unit of property" here is the building component as described above.

New or Different Use

For a building, an amount is paid to adapt the unit of property to a new or different use if it adapts the building component to a new or different use.

The regulations contain numerous additional details and examples for each of these three tests.

Conclusion

These rules and the fact that they apply to components instead of the whole building mean that there will be more capitalizations. For example, fixing a bathroom might be a small "repair" when considered as a part of the whole building, but might be a capital improvement to the plumbing system. The decision to allow the deduction of the remaining basis of the old bathroom might have been intended to offset the expanded capitalization requirement to some extent.

Good luck with new Temporary Regulations section 1.263(a)-3T.

Footnotes

[1] IRC § 6694(a), 2012(17), *Stand. Fed. Tax Rep.* (CCH), ¶ 39,955.

[2] Reg. § 1.6694-0, 2012(17), *Stand. Fed Tax Rep*. (CCH), ¶ 39,995A.

[3] Notice 2009-5, I.R.B. 2009-3, 309, *Stand. Fed Tax Rep*. (CCH), ¶ 39,960.70. CCH provides the following description at ¶ 39,957C.021: "The substantial authority standard is an objective standard involving an analysis of the law and application of the law to relevant facts. It is less stringent than the more-likely-than-not standard (which requires that there be a greater than 50-percent likelihood of the position being upheld), but more stringent than the reasonable basis standard. Several commentators have stated that it requires roughly a 40 percent possibility of success.[citations omitted]"

[4] TD 9564, I.R.B. 2012-14, 614, 4/2/2012.

[5] Carol Conjura, James Atkinson, Lynn Afeman and Catherine Fitzpatrick, *Repairs vs. Capital Improvements: New Temp. Regs. Clarify the Distinction and Require Accounting Method Changes*, 116 J. Tax'n (WG&L) 124 (March 2012).

[6] Staff of the Joint Committee on Taxation, *General Explanation of the Economic Recovery Act of 1981*, pages 85-86.

[7] IRC § 168(i)(6)(A).

[8] T.D. 9564, *Explanation of Provisions, VII. Accounting and Disposition Rules for MACRS Property*, I.R.B. 2012-14, 614, 632, 4/2/2012.

[9] Temp. Reg. 1.263(a)-3T(e)(2)(ii), 2012(5), *Stand. Fed Tax Rep*. (CCH), ¶13,704BC.

Affiliate President's Exchange National Association of Enrolled Agents, Don Wollersheim, EA

I had the opportunity to attend the APEX meeting this May representing Wisconsin Society of Enrolled Agents.

For me, the highlight of the event was the installation of Laurie Ziegler as National Board of Director. We can take great pride in Laurie's accomplishments. She is the first WSEA member to hold a national office. We are fortunate to have her representing Wisconsin on the National level.

The opportunity to meet and exchange ideas with other state representatives was a valuable experience. It was good to collect information and ideas from other chapter officers - find out what we are doing right and wrong.

The meeting included leadership training sessions on public presentations and leadership skills and communications. The speakers were excellent and the information presented was very useful.

David Williams, Director of the IRS Return Preparer Office, spoke on the current status of continuing education requirements of PTIN holders and further implementation of the RTRP testing. In 2011 there were over 800,000 PTIN holders which dropped to 752,000 for 2012. They anticipate up to 20% drop as the testing requirements take effect. This is a significant number for those who hire seasonal staff during tax season. We as business owners and Enrolled Agents must begin to prepare for the shortage of available personnel.

I found the experience very helpful and would highly recommend the future sessions to our members. Plans are to hold these sessions in two areas of the country next year so your commitment to attend will be easier.

Laurie Ziegler and the other new members of the National Board of Directors being installed.

A Short Tax Season Tale, Katie M. Jansen, EA

This year for some reason it seems like I had several of my clients asking me if they could deduct items they bought and used for work on Form 2106. Normally, I will admit I get one or two people who will ask, which is fine. I believe that part of our job as EAs is to educate our clients and make sure they are aware of what they can and can't do, but this tax season I would say I had a least half a dozen ask, if not more. Admittedly, Form 2106 does sometimes present what I like to call a "gray area". Sometimes it is blatantly obvious based on the information that a client gives you that certain items are not deductible on Form 2106, but at other times we are given very little information from our client or very little guidance from the IRS as to what is acceptable. For me "reasonable and necessary" can sometimes be a bit vague.

For example, one of my clients uses her cell phone constantly for work. This cell phone is her personal phone and the employer does not pay for it or reimburse her for any portion of her work usage on this phone. Personally, I believe that part of her cell phone usage is deductible. I have often told clients to take one of their average monthly cell phone bills and literally go through it highlighting work related calls and figure based on the total number of minutes spent for work versus for personal time what percent of the bill is for work. They then total all of their cell phone bills for the year and take that percent times the total. Now I realize the no where is it spelled out that this is an acceptable way to come up with a deductible amount, but at the same time I think it is a reasonable way to do so.

In trying to think of a tax season story to share for this newsletter, one client kept sticking out. I have been doing her taxes for three or four years and she is one of those clients that no matter what you say she puts a negative spin on it. This year she settled herself across from me and proceeded to tell me that she had finally finished school. She had worked as an EMT for years and had been taking classes on and off for about five or six years. She was always frustrated that the Lifetime Learning credit never gave her enough, if anything back. Did I mention that she has at least several kids and never had any taxable income left by the time we got to the Education Credit? Go figure. So I congratulated her on graduating and asked her if she had started to look for a job in this new field. She instantly said that she was not so sure about what she went back to school for, but yes she had a second job interview coming up for a position in her new field. She said that this would be her first face to face interview and that the company was very interested in her because of her EMT and medical background. Apparently, the job was in the insurance industry and in a professional office setting. I thought that this sounded like a great opportunity for her and said so, but she did not seem nearly as thrilled as I was. I completed her tax return and asked her if she had any concerns or questions about this new job. I asked if she was getting paid based on commission or hourly. She said that it might be both. I then asked her if she knew if she would be considered an employee of this firm or as a contractor. She was unsure about this and I further

explained the difference from a tax standpoint between the two. I think that this clarified my earlier question and she decided that she would defiantly be bringing it up in her interview.

She then asked if she would be allowed to deduct her clothing for this new job. I asked, to clarify, what kind of clothing she would be required to wear. She stated that because she would have to buy a completely new office professional wardrobe that she felt it should be deductible. In other words because she could get away with wearing blue jeans and a T-shirt as an EMT and would now be required to wear dress pants, shirts and shoes and suit coats that she should be able to deduct the cost of buying an entirely new wardrobe. I had the good grace at this point to be tactful and decided not point out that just because she chose to switch professions did not mean that she could deduct the cost of a new wardrobe. Based upon her idea, just about every college student, myself included, should have been allowed to deduct the cost of a professional wardrobe once they got a job straight out of college. Instead I stated that if these items could be worn in public without cause for notice she would not be allowed to deduct them. She retorted with the fact that she would never wear these items in public and that nurses wear their scrubs in public and they are allowed to deduct those. I responded that generally nurses in scrubs are going to or coming from work when they are seen in public in their scrubs. I then said that if an IRS auditor reviewed her return and she deducted these items the auditor would disallow it because anyone could wear

dress pants out to eat, to a special occasion, to church, etc. If these items were originally deducted and the auditor disallowed it the benefit that she got from deducting it would have to be paid back plus penalties and interest from the due date of the original tax return. She sulkily got my point, but left disappointed.

I suppose I should have explained to her that these items don't generally help most clients anyway as deduction. I have several clients who faithfully give me the total they spent on work boots and safety glasses each year and never get any benefit from it because they either do not itemize or if they do they don't have enough in expenses to get above the 2% threshold. Some clients never listen to what you tell them and some clients will never be happy with the outcome of their tax return. It is my opinion that any tax professional has to not only be cautious and inquisitive, but also have a bs detector in their back pocket.

The Dilemma of Ethics, Don Wollersheim, EA

We are proud to be Enrolled Agents and deservedly so. We worked hard to earn that designation, the privileges awarded with the recognition and the status of being among the elite in our professional industry.

But with added privileges come added responsibilities. We are held to a higher standard. We understand that and we accept the challenge. Like other organizations, we take on the responsibility and set ourselves up to be the watch dog for professional, ethical conduct within our industry. We, like the National Association, even appoint an ethics committee to take charge of that responsibility.

When we do find questionable behavior within the industry we quickly point out the questionable conduct, try to straighten out the perpetrator and correct the inefficiencies. We take pride in a job well done and are proud that we have protected our members and the public.

But that, most often, is easy – it is an unfamiliar person with a distant relationship to us. It is not emotional; it is getting the job done.

But what happens when it comes close to home – someone we know and work with. Worse yet, what if it is inside our house and acting on business on our behalf, under our name.

The tendency is to hide the problem. After all, it will go away if we just wait. We certainly want to spare ourselves and close acquaintances of the embarrassment. And so, the urge is to sweep it under the rug.

But, is not reporting unethical behavior when it is uncomfortable to do so, unethical behavior? That is the dilemma of ethics!

Supreme Court Limits IRS, David J. Fayram, EA

Hallelujah! The Supreme Court has ruled that the IRS can't issue retroactive regulations in an attempt to overrule a previous Supreme Court decision and win current litigation.[1] One would think such a decision would be obvious if the Supreme Court was to remain a separate and equal branch of the government, but four justices went the other way. Those in favor were Breyer (who wrote the decision), Roberts, Thomas, Alito, and Scalia (who had some quibbles). Those opposed were Kennedy (author of the dissent), Ginsburg, Sotomayor, and Kagen.

The underlying problem is not of much consequence unless your clients participated in Son of BOSS tax shelters. The decision provides important instruction as to how much deference should be accorded to IRS regulations. Here is the CCH summary description of the decision:

> A taxpayer's overstatement of its basis in an asset that resulted in an understatement of gross income from the asset's sale did not trigger the extended limitations period under Code Sec. 6501(e)(1)(A) because a basis overstatement is not an "omission from gross income." The previous interpretation of identical language in *Colony, Inc.*, SCt., which limited the statute's scope to situations where specific receipts were left out of the computation of gross income, controlled. The language differences between the 1939 and 1954 versions of the statute were not significant. **The IRS's argument that Reg. §301.6501(e)-1(e) was entitled to *Chevron* deference was rejected.** *Colony* already interpreted the statute and there was no longer any different construction consistent with *Colony* that the IRS could adopt. [Bolding added][2]

Regulations section 301-6501(e)-1(e) is the nefarious regulation.

Footnotes

[1] *United States v. Home Concrete & Supply, LLC, et al.*, U.S. Supreme Court, 2012-1 USTC ¶ 50,315 (April 25, 2012).

[2] *Ibid.*

Wisconsin Society of Enrolled Agents
115 E Waldo Blvd
Manitowoc, WI 54220

(920)686-1040

wsea@tm.net

www.wienrolledagents.org

"I cannot undertake to lay my finger on that article of the Constitution which granted a right to Congress of expending, on objects of benevolence, the money of their constituents..."
~ James Madison

Wisconsin Society of Enrolled Agents
Celebrating
25 YEARS
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of Serving the Tax Community

WE SPEAK TAX!