THE TAX PROFESSIONAL

Information on and discussion of issues of importance to the tax professional industry by veteran tax pro Robert D Flach

JUNE 2019

TAXPRO BUZZ

https://surlysubgroup.com/2019/05/21/the-new-kiddie-tax-needs-a-better-fix-pt-1

https://surlysubgroup.com/2019/05/21/the-kiddie-tax-needs-a-better-fix-pt-2

Sam Brunson provides a detailed two-part discussion of the new "kiddie tax" in "The Kiddie Tax Needs a Better Fix" Part 1 and Part 2 at the SURLEY SUBGROUP blog.

If you are curious about the blog title go to **https://surlysubgroup.com/2016/04/22/srly-srsly-a-tale-of-loss-and-longing-to-belong** for a lengthy explanation.

My practice is mostly middle and upper-middle class taxpayers. Prior to the creation of the Kiddie Tax I don't recall any of my clients ever temporarily transferring assets into the name of their dependent children solely for the purpose of paying a lower tax rate on the income of the investments.

My experience with the Kiddie Tax has historically been children, and more recently college students, paying a higher tax, especially on qualified dividends and capital gains, on their own investments, made from their own earned income, or investments made from permanent gifts to the "children".

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Here I go again!

One last try at a monthly newsletter for tax professionals to share information and resources and encourage discussion of issues of interest and importance to the tax preparation industry.

If you would like to join the discussion started here, comment on what I say here, have any resources or "BUZZ" you want to share, or have any topics or issues you would like to discuss in the pages of this newsletter please email me at **rdftaxpro@yahoo.com**.

VERY IMPORTANT – be sure to put "THE TAX PROFESSIONAL NEWSLETTER" in the "subject line" of your email.

And please share this newsletter with colleagues and co-workers. It is free!

THE DEDUCTION FOR DEPRECIATION OF REAL PROPERTY

For years I have been proposing a perhaps controversial tax reform idea – one that I haven't seen or heard discussed or proposed anywhere else. If I were to rewrite the US Tax Code from scratch no deduction would be allowed for the depreciation of real property, or capital improvements thereto, for any business activity – not on Form 1065, Form 1120, Form 1120S, Form 1041, or Form 1040 Schedules C, E, or F.

According to the IRS, depreciation is "*an income tax deduction that allows a taxpayer to recover the cost or other basis of certain property. It is an annual allowance for the wear and tear, deterioration, or obsolescence of the property*".

Let us look at depreciation from the point of view of the Income Statement of a business or rental activity. Basically, if you purchase an asset (i.e. equipment, a vehicle, or real estate) that will last more than one year you spread the cost of the asset over its "useful life". You purchase a new computer. You certainly do not purchase a new computer each year – you expect that it will continue to provide service for several years. So, you divide the cost of the computer over a period of years to reflect this fact, and to properly report the "economic reality" of the purchase.

If you deducted the full cost of the computer in the year of purchase this would distort the true cost of doing business. Since you generally purchase a new computer every five years, deducting the cost over a five-year period "more better" represents the cost of operations. Thus, depreciation is used to "*recover the cost or other basis of certain property*".

Another way to look at depreciation is from the Balance Sheet perspective. When you purchase an asset that asset has value to you. You trade the asset of cash for the asset of a computer. If you sold your business the value of the computer would be included in the value of the business. As an asset ages its value drops. A two-year old computer does not have the same value in the market as a comparable brand-new computer. Depreciation is used to reflect the drop-in value of the asset. Thus, depreciation is used to reflect the "*wear and tear, deterioration, or obsolescence of the property*."

A building has a life of much more than the 27.5 or 39 years over which depreciation is currently allowed. The building I lived in several years ago was 100 years old at the time, and is still going strong. And, for the most part, the value of real estate does not drop in value over the years. If properly maintained its value will generally increase. My parents purchased their first home for $13,000 and sold it many years later for $75,000 (and they were robbed). Granted real estate values can go down due to market conditions. But this is the exception and not the rule.

So, for all intents and purposes, real estate does not "depreciate". You do not replace a building every few years because it no longer provides the same service or function. And the value of real estate as a component of the value of a business does not drop as it ages. So why should we allow a tax deduction for the depreciation of real estate?

Being a "phantom expense", the deduction for depreciation of real estate distorts the economic reality of the investment activity. An activity producing a positive cash profit becomes a deductible tax loss.

Real estate is an investment, just like stocks, bonds, mutual funds, etc. You invest in rental real estate because you expect the building to increase in value over time, often more so than stocks and mutual funds, and because it generates "dividends" in the form of net "in pocket" rental income. The deduction for depreciation of real estate is like allowing those who purchase stock to depreciate the purchase price of the stock as a deduction against the dividends paid out.

Doing away with the depreciation of real property means taxpayers no longer have to deal with depreciation "recapture" when the property is sold, which would greatly simplify the overall process and reduce potential agita for the tax professional.

Where depreciation of real estate comes into play most often in the world of 1040s, at least in my 45+ years of experience, is with the rental of a 2-family building. One floor of the building is used as the personal residence of the owner and the other is rented out. Depreciation is claimed as a deduction against rental income on Schedule E and, in most cases, either creates or increases a tax loss. It is possible for the rental activity to provide positive cash flow, but because of the depreciation deduction result in a deductible loss. The depreciation deduction can increase the return's refund by up to $1,000 or more!

The problem arises when the taxpayer(s) sell the property.

With a two-family house as described above, if the required conditions are met one half of the gain on the sale, up to $250,000 or $500,000 depending on filing status, is eligible for exclusion under Section 121. The other half is taxable as a capital gain. Any depreciation "allowed or allowable" over the years must be "recaptured", or added back, to the taxable gain from the rental half of the property.

If the total net gain on the sale of the property is $100,000, generally (but not necessarily if, for example, capital improvements were made directly to the rental half) $50,000 will be allocated to the personal residence and $50,000 to the rental activity. If the taxpayer claimed $25,000 in depreciation on Schedule E over the years, or was entitled to claim $25,000 in depreciation (the "allowable" portion of "allowed or allowable"), the taxable capital gain is $75,000.

While long-term capital gain is taxed at 0%, 5%, 15% or 20%, gain resulting from depreciation recapture can be taxed at up to a maximum of 25%.

The above is the tax reality. But here is what the taxpayer will probably be thinking:

* "*I sold my personal residence and my gain was only $100,000 – so I do not have to pay any federal or state income taxes!*" – or

* "*Since it was a two-family house, I only have to pay tax on half the profit - $50,000!*"

What is "more bad" is if the sale, after claiming all closing costs from the purchase and sale and capital improvements made over the years but before factoring in the depreciation recapture, results in a net loss! If we assume $25,000 in depreciation recapture against a $5,000 loss (50%) that is $20,000 taxed at up to 25%, or $5,000 in federal tax, plus state tax on the $20,000. You have to answer your client when he screams, "but I lost money – why am I paying tax?"

It is possible that recaptured depreciation can add $12,000+ to the overall federal and state tax bill – which more often than not comes as a complete shock to the taxpayer. And, of course, I was not told about the sale, which happened in May, until I get the client's "stuff" in March of the following year. And again of course, the taxpayer did not increase withholding or make any estimated tax payments to cover the gain.

You try to explain to the client that he/she/they was/were saving $500-$1,000 each year by deducting the depreciation in the past, and now they are just paying "Sam" back – but clients cannot always understand or accept this. That $500-$1,000 per year was spent a long time ago!

So, we can see that in the long run depreciating real estate on the 1040 only results in increased “agita” for both taxpayer and tax professional.

Doing away with this deduction would provide “Uncle Sam”, and corresponding state uncles or aunts, with additional tax money up front, instead of having to wait years or decades to finally collect it. And bottom line - doing away with the depreciation deduction would more correctly tax the actual economic activity.

So, what do you think?

<u>TAXPRO BUZZ</u> *(continued from Page 1)*

https://www.natptax.com/EventsAndEducation/Pages/1040-overview.aspx

The National Association of Tax Professionals has published the topics and dates and locations for its annual year-end 1040 WORKSHOPS. At least day one is a “must attend” event. I will be attending both days in Atlantic City.

https://www.taxprotoday.com/news/tax-season-2019-lessons-learned

Roger Russell shares the thoughts of tax professionals on “Tax Season 2019: Lessons Learned” at TAXPRO TODAY.

“*In a survey of tax professionals by the National Center for Professional Education Fellowship, 74 percent of respondents said that this filing season was more difficult than last year, with over half citing the Section 199A pass-through deduction as the No. 1 issue. Ninety-six percent said they were negatively affected by the February release of final 199A regs*.”

Clearly a tax pro’s experience with the season depended on the types of clients he or she has and the issues involved with the returns prepared. I certainly did not find the season “painful”, as one tax pro’s response indicated. Many returns were simpler, considering the inability of most of my clients to itemize due to the increased Standard Deduction and the loss and limitation of deductions. While I may not agree with the changes on a philosophical level, I did not complain about the reduced work and agita that resulted.

Two good observations from fellow tax pros in the article –

“*We also learned that there’s a difference between a tax preparer and a tax professional. . . . A true tax professional took the time to go over the return and explain to clients how they gained from tax reform, and how they lost*.”

I have always provided a detailed “The Word” memo with a finished return explaining the differences between the current return and the previous year’s return and what needs to be done going forward.

And perhaps most important –

“*This filing season underscores the need for professionals who understand what a return should look like without having to rely on their software*.”

Sadly, many tax preparers today are merely data entry clerks and not true tax professionals.

For my take on the 2019 tax filing season check out "That Was The Tax Season That Was" Part I and Part II -

http://wanderingtaxpro.blogspot.com/2019/04/that-was-tax-season-that-was-part-one.html

http://wanderingtaxpro.blogspot.com/2019/04/that-was-tax-season-that-was-part-two.html

And fellow tax blogger Russ Fox of TAXABLE TALK seemed to think it was a miserable filing season -

http://www.taxabletalk.com/2019/04/30/the-2019-tax-season-part-1-a-miserable-year

So, how was your season?

http://wanderingtaxpro.blogspot.com/2019/05/what-is-tax-preparer-essay-on.html

I am also interested in your comments on the above essay on responsibility, regulation and due diligence.

SO, YOU WANT TO BE A TAX PREPARER

I have been preparing 1040s as a professional tax preparer since February of 1972. I love my profession, and share my advice and comments on the tax preparation business for those who are thinking about becoming a paid tax preparer in SO YOU WANT TO BE A TAX PREPARER.

This book can also provide help to tax preparers who would like to expand their practice.

In this book I discuss in detail -

- ✓ LEARNING HOW TO PREPARE TAX RETURNS
- ✓ THE PTIN
- ✓ TAX PREPARER MEMBERSHIP ORGANIZATIONS
- ✓ CONTINUING PROFESSIONAL EDUCATION
- ✓ PROFESSIONAL RESPONSIBILITY – ETHICAL STANDARDS AND PRACTICES
- ✓ BUILDING A PRACTICE
- ✓ USING A BLOG TO PROMOTE YOUR TAX PRACTICE
- ✓ GETTING A CREDENTIAL
- ✓ STRUCTURING YOUR TAX PRACTICE

The APPENDIX includes copies of a Code of Ethics, Standards of Professional Conduct, an Engagement Letter, and the TAX PROFESSIONAL'S ONLINE RESOURCE GUIDE.

Andy Frye of the Pronto Tax School said about this book in a review,"*Mr. Flach's book . . . should be required reading for anyone who's considering getting into the tax business as a tax preparer*." To read the full review go here - **https://prontotaxclass.com/pronto-tax-blog/977-my-review-of-robert-flach-s-new-book-so-you-want-to-be-a-tax-preparer**.

The cost of this book is only $5.45 delivered as a pdf email attachment, or $9.45 for a print version sent via postal mail.

Members of the National Association of Tax Professionals receive a 25% discount on both versions.

An e-book version Kindle is also available from Amazon (no NATP discount). Go to - **https://www.amazon.com/dp/B075HY9LRY/ref=sr_1_1?s=digital-text&ie=UTF8&qid=1505068995&sr=1-1**.

IRS RELEASES DRAFT OF 2020 FORM W-4

At the end of May the IRS released a draft form of the 2020 Form W-4. To download a copy of this draft, go to **https://www.irs.gov/pub/irs-dft/fw4--dft.pdf**.

The revised Form W-4, still a work in process, will not be effective until 2020.

The recent tax filing season proved that the current federal withholding system is outdated. Most of my clients were under-withheld for 2018 – with some owing thousands of dollars to Sam as a result,

I have not had a chance to review in detail the draft form, but it certainly looks complicated.

According to the IRS Information Release (**https://www.irs.gov/newsroom/irs-treasury-unveil-proposed-w-4-design-for-2020**) –

"*The IRS expects to release a near-final draft of the 2020 Form W-4 in mid-to-late July to give employers and payroll processors the tools they need to update systems before the final version of the form is released in November. To make additional improvements to this initial draft for 2020, the IRS is now accepting comments for 30 days*."

You can submit your comments on the draft form to the IRS at- **https://www.irs.gov/forms-pubs/comment-on-tax-forms-and-publications**.

Until the withholding situation, and the W-4, is properly figured out my advice to **ALL** taxpayers in **ALL** situations is to claim "Single-0" or "Married, but withheld at higher Single rate-0" on **ALL** W-4s.

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*We must never forget that **ABSOLUTELY NOTHING** – no other issue – is more important for the future of America, American democracy, and the world in the 2020 election than removing Trump from the White House (if he lasts that long), and removing hypocritical Republicans who support and defend Trump from Congress.*
