TAX UPDATE

Ed Zollars, CPA

By the Form—New IRS Schedule D Instructions
December 24, 2005

Feed address for Podcast subscription:
http://feeds.feedburner.com/EdZollarsTaxUpdate
Home page for Podcast: http://ezollars.libsyn.com

The TaxUpdate podcast is intended for tax professionals and is not designed for those not skilled in independent tax research. All readers and listeners are expected to do their own research to confirm items raised in this presentation before relying upon the positions presented.

The Podcast and this document may be reproduced freely so long as no fee is charged for the use of this document. Such prohibited use would include using this podcast or document as part of a CPE presentation for which a fee is charged.

The podcast is sponsored by Leimberg Information Services, who provide to their subscribers email newsletters and resources of use in tax practice. Visit their website at http://www.leimbergservices.com.

Schedule D-1 Saga

The IRS gave those who prepare tax returns and those who have large numbers of investment transactions a Christmas "gift" of sorts in the Schedule D instructions for 2005. This weeks the American Institute of Certified Public Accountants' Tax Division sent out an email noting that the instructions for Schedule D this year contain the following addition as compared to prior years for what to do if the number of transactions a taxpayer enters into exceeds the number of lines on Schedule D:

> You must enter the details of each transaction on a separate line. If you have more than five transactions to report on line 1 or line 8, report the additional transactions on Schedule D-1. Use as many Schedules D-1 as you need. Enter on Schedule D, lines 2 and 9, the combined totals from all your Schedules D-1.
>
> Do not enter "see attached" and summary totals from an attachment in lieu of reporting the details of each transaction directly on Schedule D or D-1.

The last paragraph is what constituted "new" material in the instructions, and has caused quite a bit of commentary in online discussions groups.

If you don't do tax return preparation, some background may be in order to understand why CPAs and EAs are so upset by this change.

Many clients receive printed tax reporting summaries from their brokerage firms that analyze the securities they have sold during the year, and give totals for short term and long term transactions. As well, other clients print out similar summaries from programs like *Quicken* that give similar information. Many tax preparers have grown used to transferring such totals to Schedule D with a notation to "See Attached Schedule" in lieu of entering what may be hundreds of individual line items directly into their tax software.

Adding to the confusion is that while the above instruction is found on page D-6 of the instructions, on page D-3 the following instructions directed at traders specifically allows a an attachment:

> *Like an investor*, a trader must report each sale of securities (taking into account commissions and any other costs of acquiring or disposing of the securities) on Schedule D or D-1 *or on an attached statement* containing all the same information for each sale in a similar format. (emphasis added)

While this instruction tells us a trader reports like an investor, the instruction goes on to allow a reporting method that appears to be prohibited for an investor three pages later.

Some may wonder why this is important or why the IRS may be doing this. We will consider both issues.

The Importance of Instructions

At first glance this might appear to be much ado about nothing. After all, we all know and have read quite often in Tax Court opinions that the instructions are not binding on the IRS when taxpayers have cited them to attempt to justify their position. That leads some to conclude that, essentially, instructions are no big deal.

Unfortunately, while that is true for the IRS, it's not necessarily true for taxpayers. A couple of specific problems arise with failing to follow the instructions, especially as regards the use of specified forms.

The IRS is granted authority to require the use of the forms they design. Section 6011(a) provides:

> 6011(a) GENERAL RULE. -- When required by regulations prescribed by the Secretary any person made liable for any tax imposed by this title, or with respect to the collection thereof, shall make a return or statement according to the forms and regulations prescribed by the Secretary. Every person required to make a return or statement shall include therein the information required by such forms or regulations.

The IRS implemented this provision via Regulation §1.6011-1(a) and (b) which provide:

> §1.6011-1. General requirement of return, statement, or list
>
> (a) *General rule.* --Every person subject to any tax, or required to collect any tax, under subtitle A of the Code, shall make such returns or statements as are required by the regulations in this chapter. *The return or statement shall include therein the information required by the applicable regulations or forms.*
>
> (b) *Use of prescribed forms.* --Copies of the prescribed return forms will so far as possible be furnished taxpayers by district directors. A taxpayer will not be excused from making a return, however, by the fact that no return form has been furnished to him. Taxpayers not supplied with the proper forms should make application therefor to the district director in ample time to have their returns prepared, verified, and filed on or before the due date with the internal revenue office where such returns are required to be filed. Each taxpayer should carefully prepare his return and set forth fully and clearly the information required to be included therein. *Returns which have not been so prepared will not be accepted as meeting the requirements of the Code.* In the absence of a prescribed form, a statement made by a taxpayer disclosing his gross income and the deductions therefrom may be accepted as a tentative return, and, if filed within the prescribed time, *the statement so made will relieve the taxpayer from liability for the addition to tax imposed for the delinquent filing of the return, provided that without unnecessary delay such a tentative return is supplemented by a return made on the proper form.*

The italicized portions of the regulation hint that a taxpayer who ignores the requirements to file the prescribed forms (in this case the Schedule D-1) and/or does not prepare those forms in accordance with the instructions may cause the return to be deemed a delinquent return.

As well, remember in last week's podcast we discussed the issue relating to Revenue Procedure 2005-75 and the requirement to have reported in accordance with the instructions in order for the taxpayer to avail him/herself of the adequate disclosure defense against the substantial understatement penalty for a "reasonable basis" position.

So taxpayers who do not follow the instruction to not attach a statement and report all transactions in detail on Schedule D-1 face significant uncertainly on the status of their return, as well as exposure to penalties—unless, of course, they are a trader (despite the almost complete lack of apparent justification for that exception to this author).

Why the New Instructions?

A lot of speculation has emerged in the discussion groups about why the IRS has chosen to go this route. While it's difficult to know exactly why the IRS has chosen now to stake out a position on this matter, a couple of justifications would seem reasonable.

Tax shelter abuse of netting on Schedule D. On the California Society of CPA's TaxTalk

group, a discussion emerged suggesting on reason for this new instruction may be that certain tax shelters from the 1990s were sold to individuals to offset large capital gains with similarly large losses, and that by putting these transactions on separate schedules that may not have been easy to decipher, the taxpayers were able to hide the fact that they had both large gains from normal transactions and a large offsetting loss from a single transaction.

By forcing such transactions onto Schedule D-1, the IRS would help insure that either they could attempt to automate a scan for such items (presuming they can get the data entered into their system) or, at least, insure their agents would be able to do such a scan quickly when surveying a return since the data would always be located in a consistent location and presented in a consistent format. James Counts, CPA, moderator of the TaxTalk group, mentioned that IRS personnel had specifically mentioned such "netting" schemes when discussing what they saw as abusive tax shelters.

Efiling. Another potential issue that may have driven this is the issue of electronic filing. For a long time there has been an issue that practitioners have had with electronic filing of the returns where large numbers of transactions were reported on brokerage firm schedules. I was personally involved with an AICPA Tax Section project back in the late 1990s regarding what was then seen as low CPA participation in efiling where one of the issues put forward by the AICPA group was the problem of dealing with clients with large number of brokerage firm transactions that received this summary data, and how that could be handled since there was no officially sanctioned method to attach such data to an efiled return short of rekeying all of the entries.

While many practitioners reported various methods were "blessed" in informal discussions with local IRS efile employees, attempts to get an officially blessed method through the IRS National Office stalled on numerous occasions. What occurred in that vacuum was that some practitioners began to either send in the paper schedules as attachments with a paper efile authorization or they would put "details available on request" in the electronic file.

However many others (including myself) had grave reservations about either of these approaches should an issue arise on exam, since neither option had any officially binding blessing and both appeared to be contrary to what did exist in binding form (including the regulations cited above). The AICPA group I was a part of specifically attempted to get the IRS to accept allowing the preparer to provide details on request, as did other groups that attempted to resolve this matter later. In all cases, the IRS in the end did not issue any guidance to bless such an arrangement.

Last year the IRS began giving clear signals that efilers should not send anything paper with a paper authorization except items specifically authorized to be sent in that fashion. Assuming the "information to be provided on request" option was inadequate (and it certainly appears to be directly in conflict with the regulation cited above since Schedule D did request the detail), that left only reentering all of the detailed transactions in order to efile. That means that if "See attached schedule" was acceptable for a paper return (since it

did provide all requested information), then there would be a significant additional cost to the taxpayer to efile a return if the taxpayer had numerous trades reported on such summaries.

Looking at it this way, the IRS may have issued this "clarification" of the Schedule D instructions in order to help encourage electronic filing, something the United States Congress clearly is interested in the IRS doing. That would also suggest the IRS might be very insistent on preparers not "ignoring" this rule and might want to "make an example" of some preparers in the upcoming season.

What to Do?

Preparers are faced with a real dilemma. The solutions will vary based on the situation, but the following options need to be considered.

Inform clients of the issue. This is a key first step, since they are the ones that will bear the costs of compliance or face the penalties and consequences of noncompliance should the IRS decide to hang tough on this one. Clients need to be warned that paper statements from their brokers are not now being deemed adequate for filing purposes, and that such data will need to be reentered into the preparer's system. Clients will either need to get their brokers to prepare official Schedule D-1s (that is, government approved one) or be able to get the data in a form the preparer's software can work with.

Software import. Preparers should take a look at options that may exist to import the data, as well as options to obtain the data from the broker in a form that can be imported. Some tax software (such as CCH's *ProSystemFX* and Intuit's *Lacerte*) have methods available to import data either from various file formats, though quite often the method is not necessarily easy to discover. Now would be a good time to go thorugh manuals to find out what is possible.

Noncompliance. Many preparers are suggesting they will ignore the issue unless the IRS actually starts taking action. While it's very possible this will work, preparers should not take this step lightly, especially without clear client consent. The client's return is what is at risk in a case like this, and should the IRS decide to throw the book at the client, a client who had this decision made for them will justifiably look to the professional to make them whole. As well, it is possible, depending on the actual IRS reason for taking this step, that there could be preparer penalties or other disciplinary actions taken in this area, especially if a later exam results in an adjustment to an item reported "erroneously" using either schedules or the "information to be provided on request" option.