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TAX in the News

Tax Information for Tax Practitioners

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TAX NEWS

Final Due Diligence Regulations Now Cover Head of Household Filing Status—The TCJA expanded tax return preparer due diligence requirements to include head of household filing status. Tax professionals must ensure that this status is used only by a taxpayer who is unmarried or considered unmarried and provides more than half the cost of maintaining a home for a dependent qualifying child or qualifying relative. As with all tax benefits covered under the due diligence regulations, to avoid the §6695(g) penalty the preparer must ask appropriate questions and document answers. Also, due diligence requirements apply to the new credit for other dependents. Page 2

Disaster Relief: California—Parts of California have been declared major disaster area because of wildfires starting November 8, 2018. Federal deadlines for affected taxpayers are generally postponed until April 30, 2019. This includes 2018 individual income tax returns due April 15, 2019. Disaster-related casualty losses may be claimed on 2017 or 2018 tax returns. Page 3

QUESTION OF THE WEEK

Our clients moved out of their condo six years ago and decided to rent it out because the market and the condo's value were both down and they weren't sure of their plans. Depreciation was based on the FMV at the time. They've now sold the condo for more than the FMV at the time of the conversion but still less than what they originally paid for it. Do they have a gain or a loss on the sale and how would it be calculated? Page 4

ORIGINAL INSIGHTS

Partnerships, Part III: Partnership Audit Procedures — The Bipartisan Budget Act of 2015 changed partnership audit procedures in several ways. Full insight. View all insights at www.thetaxinstitute.com/insights/.

FINAL DUE DILIGENCE REGULATIONS NOW COVER HEAD OF HOUSEHOLD FILING STATUS

The Treasury Department and IRS have issued final regulations covering the §6695(g) tax return preparer penalty for failure to exercise due diligence. Originally, due diligence requirements covered only tax returns claiming the EITC. In 2015, requirements were expanded to include the child tax credit/additional child tax credit (CTC/ACTC) and the American opportunity credit (AOC). Under the TCJA, due diligence was again expanded to apply to head of household filing (HOH) status as well. Although not specifically mentioned in the regulations, because the new credit for other dependents (ODC) is part of the CTC (§24(h), it falls under due diligence too. See IRS news release IR-2018-216.

Examples. In Example 5 in the regulations, an unmarried taxpayer wishes to file as HOH with the taxpayer's niece and nephew as qualifying individuals. In order to meet the due diligence knowledge requirement, the taxpayer must make reasonable inquiries to determine if the taxpayer is eligible to use the HOH filing status. These may include questions about the children's residency, sources of support, and relationship to the taxpayer and the taxpayer's contribution to household costs.

Example 6 has the same facts but states that the preparer knows this taxpayer and the children socially and knows that eligibility requirements are met. The regulations explain that, nonetheless, the preparer is required to ask appropriate questions and contemporaneously document inquiries and responses.

Form 8867 changes. Form 8867, *Paid Preparer's Due Diligence Checklist* and Form 8867 instructions have also been revised to reflect the latest tax law changes. The revised form includes only one question specific to HOH due diligence:

> Have you determined that the taxpayer was unmarried or considered unmarried on the last day of the tax year and provided more than half of the cost of keeping up a home for the year for a qualifying person?

However, the instructions point out that all HOH eligibility requirements must be met even if the preparer answers "yes" for this question. That means the taxpayer must have a dependent qualifying child or qualifying relative to use this filing status.

Penalties. Under the regulations, penalties apply separately for each type of tax benefit subject to due diligence requirements. An example is provided of a preparer who does not meet due diligence requirements with respect to the child tax credit and HOH filing status with the same child as qualifying individual. In that case, the preparer faces two due diligence penalties. The penalty is $520 per incidence for tax returns filed in 2019.

Head of household reminders. As stated earlier, in order to use this filing status the taxpayer must be unmarried or considered unmarried and pay more than half the cost of maintaining a home for a qualifying person. Here are a few reminders:

- Even though the exemption amount is $0, the taxpayer must meet all requirements to claim a qualifying child or qualifying relative for head of household purposes.
- A taxpayer may qualify if he or she maintains a home for a parent who lives in a different home from the taxpayer's home. Otherwise, all other qualifying people must share the same main abode as the taxpayer for more than half the year.
- For that reason, a noncustodial parent will not typically qualify to file as HOH because, by definition, the child lives with the custodial parent.
- To be *considered unmarried*, the taxpayer must live apart from his or her spouse for the second half of the year and maintain a home for a son or daughter (including stepchildren and adopted children). Other dependents, including grandchildren, siblings, and parents may be qualifying people for other tax benefits but not for purposes of treating a taxpayer as unmarried for HOH filing purposes.

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- An unrelated or distantly related individual who is a dependent only because he or she is in the same home with the taxpayer the entire tax year is not a qualifying person for HOH.
- An individual who is a dependent because of a multiple support agreement is not a qualifying person for HOH.

Effective date. The final regulations generally apply to years beginning after December 31, 2015 for returns prepared on or after December 5, 2016 (starting with tax season 2017 for most returns). The head of household rules apply to tax years beginning after December 31, 2017 for returns prepared on or after December 7, 2018 (starting with tax season 2019 for most returns).

DISASTER RELIEF—California

Parts of California have been declared major disaster areas eligible for federal disaster aid to individuals and businesses. As with all federally declared disasters, be sure to check the IRS and FEMA links for updates to the covered disaster area.

Affected taxpayers have the option of waiting to claim 2018 disaster-related casualty losses on their 2018 tax return filed next year during the 2019 tax season or on an original or amended tax return for 2017 filed during 2018. In addition, the IRS has postponed deadlines for affected taxpayers to file returns, pay taxes, and perform other time-sensitive acts.

Affected taxpayers are those who:

- Live in the covered disaster area
- Have a main place of business located in the covered disaster area
- Have books and records needed to complete the return located in the disaster area
- Assist governments or qualified non-profit organizations in relief efforts
- Were injured or killed while visiting the area

Note: Generally, the IRS identifies affected taxpayers located in the disaster area and automatically applies filing and payment relief. Affected taxpayers outside the disaster area should call the IRS at 1-866-562-5227 to request tax relief.

California disaster: wildfires starting November 8, 2018.

FEMA major disaster declaration announcement: DR-4407 dated November 12, 2018.

IRS release: CA-2018-13, dated November 13, 2018.

Covered disaster area: Butte, Los Angeles, and Ventura counties.

Postponement periods: Tax returns and other time-sensitive acts due on or after November 8, 2018 and before April 30, 2019, are postponed until **April 30, 2019.** This includes 2018 tax returns due April 15, 2019, quarterly estimated tax payments due January 15 and April 15, 2019, and quarterly payroll and excise tax returns due January 31, 2019.

Employment and other excise tax deposits due on or after November 8, 2018, and before November 23, 2018, must be deposited by November 23, 2018.

California tax relief: California taxpayers may deduct a disaster loss for any disaster-related loss sustained in an area that is proclaimed by the Governor to be in a state of emergency. Note: This link is not yet, but likely soon will be, updated for the latest round of wildfires.

QUESTION OF THE WEEK

Q. About six years ago our clients retired, moved, and bought a new home. At that time, they weren't sure what they wanted to do with their old home (a condominium), especially since the market had not quite turned around and the condo was worth less than what they paid for it. They decided to rent it out, which they have done since then. Their tenant moved out this year and they sold the condo for approximately $95,000. The cost basis of the condo was $125,000 and it was valued at $90,000 when they converted it to a rental. Allowable depreciation was $17,000. Do they have a gain or a loss on the sale and how would it be calculated? (Depreciation was calculated only on the condominium itself, although it was in a large building, and their share of the land was minimal. We've approximated and rounded all the numbers.)

A. Your clients do not have a gain or a loss on the sale.

Gain computation. Gain on the sale of rental property is computed using the adjusted cost basis (cost plus improvements) less depreciation. Using your figures, cost less depreciation is equal to $108,000 ($125,000 - $17,000). Had the property been sold for *more than* $108,000, gain would be the difference between the sales price and $108,000, the adjusted cost basis less depreciation.

Loss computation. When a principal residence is converted to a rental property, any allowable loss is computed using the lower of adjusted cost basis less depreciation or FMV less depreciation. Here, the result is $73,000 ($90,000 - $17,000). If the property had been sold for *less than* $73,000, the loss would be the difference between the sales price and $73,000, the FMV basis less depreciation.

In this case, the $95,000 sales price is between cost basis minus depreciation ($108,000) and FMV minus depreciation ($73,000). The result is that the client does not have reportable gain, or a deductible loss, or depreciation recapture. That is because the gain calculation doesn't result in a gain and the loss calculation doesn't result in a loss.

See "Property changed to business or rental use" in IRS Pub. 544, *Sales and Other Dispositions of Assets.* Of course, you'll have to use the actual numbers to make sure the sale result is not a gain or a loss.