THE TAX INSTITUTE AT H&R BLOCK

TAX in the News

Tax Information for Tax Practitioners

Special Edition: Question of the Week July-September 2018

Question of the Week

Topics Covered July-September 2018

July 11, 2018: Dependents in Canada or Mexico. In prior years, several of our clients were able to claim an exemption for dependents who live in Canada or Mexico. Will these dependents now qualify for the new $500 credit? Are there any other tax benefits for dependents in Canada or Mexico that may be claimed under the new law?

July 25, 2018: Two main home sales within two years. Clients sold their main home and moved permanently into a second home they've owned for years and used for vacations. They've decided the house isn't suitable as their full-time residence and expect to buy another house in the near future. If they decide to sell this second "main" home when they buy the next house, will they be able to exclude any of the gain?

August 1, 2018: Undepreciated equipment and loss of 2% itemized deductions. A client who is employed by a construction company will no longer be able to deduct his out-of-pocket expenses, including depreciation on tools and equipment he uses on jobs. He had previously opted out of bonus depreciation for these items. Has he just lost out on the remaining depreciation after 2017, or is there something he can do to recoup some of his costs?

August 8, 2018: Basis of new truck received in non-§1031 exchange. A contractor recently traded in a pick-up truck and paid additional cash to get a new one. In prior years this kind of trade would have been a like-kind exchange, which he cannot do in 2018. How does he determine his basis in the new truck?

August 22, 2018: 401(k) withdrawal to pay ex-spouse's legal fees. A client withdrew a large sum from his 401(k) to cover his ex-spouse's legal fees. The divorce court judge had ordered him to pay the expense and he did not have any other way to cover it at the time. Would this distribution be considered a QDRO? If not, is there any way for him to avoid the tax and penalty on the distribution?

August 29, 2018: RMDs from inherited IRA. A client will start receiving RMDs from an inherited IRA. She is working and has a traditional IRA. She would like to set up automatic deposits of the inherited IRA's RMDs into her own IRA. If so, could she treat each deposit as a deductible contribution or, if not, as a nondeductible contribution that increases her IRA basis?

September 12, 2018: Filing status for married taxpayer with family in Mexico. A Mexican citizen has been living and working in North Carolina for a few years. Her husband and children live in Mexico and have ITINs. In previous years, appropriate elections were made so that she can file jointly with her husband and claim exemptions for their children. Now that there are no personal or dependent

exemptions, what should her filing status be for 2018? Should she change her filing status to single, head of household, or MFS?

September 19, 2018: Unrelated dependents in taxpayer's home. For several years a client has been claiming dependent exemptions for his fiancé and her daughter. They live in his home and he is their sole support. In 2018 will he be able to claim the new $500 credit for them? Can he now file as head of household or claim other tax benefits?

September 26, 2018: Multiple casualty losses and casualty gain. Our clients had a difficult year, sustaining damage to both their main home because of a flood and their vacation home because of a fire. Their main home is in a county that was declared a major disaster area because of the flooding. They'll have a loss on that home. However, they will have insurance gain from the fire damage to their vacation home, but a loss on the car they kept at that site. How does the new law affect their casualty losses? Are they stuck paying tax on the gain because the fire was not in a disaster area?

JULY 11, 2018

Q. We have several clients who have dependents living in Canada or Mexico. The dependents are not U.S. citizens or residents. All have ITINs. Do they qualify for the new $500 credit? How else will the new tax law affect these clients in 2018?

A. As under prior law, only a few tax benefits will be available under the TCJA for dependents who reside in Canada or Mexico. Here, let's assume the taxpayer and dependent do not live together, i.e. the taxpayer resides all year in the U.S. and the dependent resides all year in Canada or Mexico, and that the dependent is not a U.S. citizen or U.S. resident, such as a greencard holder.

Dependent exemptions are suspended but dependent-connected tax benefits may be available. Before the TCJA, a taxpayer could claim an exemption for a dependent living in Canada or Mexico. The TCJA suspends exemptions for tax years 2018-2025. However, the qualifying child and qualifying relative rules are still in place as are the rules for claiming any other dependent-connected tax benefits.

In this situation, a potential dependent in Canada or Mexico would be a qualifying relative rather than a qualifying child because the taxpayer and dependent do not have the same principal place of abode. The taxpayer must provide more than half of the dependent's support and meet all other qualifying relative tests. For the gross income test, the dependent's income must be no more than $4,050 (for 2018), just as though the exemption were still available.

Head of household filing status could be available under limited circumstances. Since head of household filing status requires the taxpayer to pay more than half the cost of maintaining a home that the taxpayer and dependent share, this status would not apply when the two do not live together. However, there is an exception if the dependent is the taxpayer's parent. Therefore, a taxpayer who pays more than half the cost of maintaining the home of a dependent parent who resides in Canada or Mexico may file as head of household. As explained above, the dependent parent must otherwise meet all qualifying relative tests.

The child tax credit and EITC are still not available for children in Canada and Mexico. For several reasons, dependents who are residents of Canada or Mexico do not qualify for the CTC or EITC. First, these tax benefits

apply only to qualifying children and not to qualifying relatives. The CTC may not be claimed for a child who is not a U.S. citizen or resident. For the EITC, the taxpayer and child must also reside in the U.S. (or on a U.S. military base), even if the child is a U.S. citizen. The TCJA has not changed these rules and has added a further restriction that a child must have an SSN to claim the CTC.

The new $500 "non-child" credit is not available for dependents in Canada or Mexico who are not U.S. citizens or residents. The TCJA introduced a new credit for other dependents who do not qualify for the CTC, such as older children and parents. The new credit does not have an SSN requirement, so it could also potentially be claimed for a younger child with an ITIN living in the U.S. However, the new credit has the same rule that applies to the CTC. That is, the credit may be claimed only for a dependent who is a U.S. citizen or resident. Dependents who are residents of Canada or Mexico will not be eligible for the new credit.

Other dependent connected benefits. Facts and circumstances determine whether a taxpayer could claim other tax benefits for a dependent in Canada or Mexico. For example, a taxpayer who itemizes may be able to deduct unreimbursed medical expenses paid for a dependent qualifying relative living in Canada or Mexico. On the other hand, a taxpayer would probably not be able to claim the credit for the cost of child and dependent care, even if the taxpayer pays these expenses, unless the taxpayer and dependent share the same abode in Canada or Mexico.

JULY 25, 2018

Q. Earlier this year our clients sold the main home they owned and lived in for over 15 years. They will qualify to exclude all of the gain on the sale. They then moved into a second home they bought about five years ago. Although they spent vacations, long weekends, etc. at this home, they've found it doesn't really suit their needs as their full-time residence. They expect to buy another house later this year or early next year. If they decide to sell this second/main home will they be able to exclude any of the gain? In all, it would be their main home only about a year.

A. Your clients will not be able to exclude any of the gain on the sale of the vacation home that later became their main residence.

First, the period of time that the home was used as a vacation home is referred to as a period of "nonqualified use" and the gain allocated to that period is "non-residence gain." For example, suppose they sell it after owning it six years and living in it one year and the gain on the sale is $30,000. The non-residence gain on the sale would then be $25,000 ($30,000 gain × 5/6). This gain is fully taxable.

Second, if your clients sell the home, the remaining gain of $5,000 is residence gain that is potentially eligible for the §121 exclusion, but it will not be eligible if they used it as their primary residence for less than two years.

In some circumstances, taxpayers may qualify for a partial exclusion if they sell a home before the two- year residency requirement is satisfied. These include sales and moves related to work, health, and other unforeseeable events. See "Partial exclusion may be available" in IRS Pub. 523, Selling Your Home for details on the partial exclusion and how to calculate it.

Third, taxpayers generally cannot claim the exclusion if they used the exclusion for any residence sold or exchanged during the two-year period ending on the date of the current sale or exchange. However, if the sale was due to a change in place of employment, health, or unforeseeable events, the taxpayer may be able to claim a partial exclusion as discussed above.

As you've described the situation, it appears that your clients just prefer a different type of home to use as their main residence and that no unforeseen event has occurred. However, if one of the special circumstances applies to them, they could qualify for the partial exclusion

If your clients decide to remain in this home for the full two-year residence period, they will be able to exclude all of the *residence* part of the gain. Whatever part of the gain is allocated to nonqualified use will be taxable.

AUGUST 1, 2018

Q. My client is employed by a construction company and uses his own tools and equipment for work. In 2016 he made several purchases of expensive equipment. After some discussion, he decided to opt out of bonus depreciation. The reasoning at the time was that regular depreciation, along with some other employee business expenses, would likely put him over the 2% of AGI threshold for the next several years. That plan worked well for 2016. He has not yet filed his 2017 taxes. Now that employee business expenses are not deductible, has he just lost out on deducting the rest of the cost of the equipment beyond what he can deduct for 2017? Can he reverse his earlier decision and opt into bonus depreciation for 2016?

A. The election to opt out of bonus depreciation can be revoked only with the IRS's consent. However, your client may be able to recover more of the equipment costs by claiming the §179 deduction on an amended 2016 return. Under the PATH Act, taxpayers may make the §179 election on an amended return without the IRS's consent. The election must be made for the year the property was placed in service. See Rev. Proc. 2017-33, section 3.02.

Note that §179 cannot be used to create a loss and you mentioned that this equipment was "expensive." If your client's salary and other business income he may have aren't sufficient to absorb the deduction, the unused deduction may be carried over to his 2017 return.

Another point to consider, assuming your client does not carry over part of the §179 deduction to 2017, is that by losing regular depreciation for 2017, his other miscellaneous expenses may be less than 2% of his AGI and he would lose the deduction altogether. Therefore, it's important to run the numbers to compare increasing the cost recovery in 2016 against the loss of the deduction in 2017.

If your client had already filed his return for tax year 2017 with the regular depreciation deduction and later claimed the §179 deduction for 2016, the 2017 return would need to be amended too.

For tax years 2018 through 2025, as you know, employee business expenses and other "2%" miscellaneous expenses are not deductible.

AUGUST 8, 2018

Q. A contractor traded in one of his pick-up trucks for a new one. The dealer gave him $12,000 for the trade-in and he paid $18,000 in cash. His remaining basis in the old truck was about $10,000. Since he cannot do a like-kind exchange in 2018, how does he determine his basis in the new truck? He uses the trucks exclusively for his business.

A. Your client's basis in the new truck will be $30,000, which is what he paid to purchase it: $12,000 trade-in value plus $18,000 in cash. He will also recognize gain of $2,000 ($12,000 trade-in -- $10,000 adjusted basis) on this transaction.

Had this been a like-kind exchange, the §1245 gain on the exchange would have been deferred and your client's basis in the new truck would have been adjusted accordingly. Thus, his basis would have been $28,000 ($30,000 purchase price -- $2,000 deferred gain). Stated another way, the $28,000 basis in the new truck would consist of $10,000 carryover basis plus the $18,000 boot.

Under the TCJA, §1031 like-kind exchange treatment is available only for exchanges of real property. For a vehicle trade-in or other personal property exchange that no longer qualifies for §1031 treatment, the taxpayer's

basis in the new property is essentially the purchase price of that property, which will be whatever the seller allows for the old property plus the taxpayer's cash outlay. Realized gain or loss on the exchange is immediately recognized.

To illustrate further, suppose the trade-in value on the old pick-up was only $8,000 and your client had to pay $22,000 to get the new one. In that case, he would recognize a $2,000 loss immediately and basis in the new vehicle would again be $30,000, consisting of the $8,000 trade-in value plus $22,000 in cash.

For depreciation purposes, the entire $30,000 is the depreciable basis. Because the transaction is not a like-kind exchange, there is no breakdown between "carryover" and "new" segments to consider or election needed to group the two amounts. See the Business and Auto Inflation-Adjusted Amounts chart for 2018 depreciation amounts for the new truck.

AUGUST 22, 2018

Q. Our client was divorced in 2017. During the court proceeding, the judge ordered him to pay his spouse's legal fees. He didn't have the money then and there but was allowed to take the amount from his 401(k) plan. Would this be considered a qualified domestic relation order? If not, is there anything he can do to avoid the tax and penalty on the distribution? He is 40 years old.

A. Given the circumstances you've described, the distribution from your client's 401(k) plan was not made under a qualified domestic relation order (QDRO).

A QDRO is a judgment issued under a state's domestic relations law that recognizes a spouse or other family member as having the right to a plan participant's benefits as part of support requirements. The QDRO must specify the amount or percentage to be paid to the alternate payee. The distribution is not subject to penalty and is taxable to the recipient rather than the plan participant. See "Qualified Domestic Relations Order" in IRS Pub. 504, *Divorced or Separated Individuals*.

Your client was ordered only to pay an expense but not to set up a QDRO. Apparently, his plan allowed him to take a hardship distribution, but the distribution is taxable and subject to the early distribution penalty unless an exception applies. For example, he may have some uncovered medical expenses which would eliminate the penalty for at least part of the distribution.

If a similar financial contingency arises in the future, your client might consider taking a loan, rather than a distribution from his 401(k) or find another means to cover support expenses.

AUGUST 29, 2018

Q. A client inherited an IRA from her late brother. He was over 70½ and was receiving required minimum distributions for several years. The client is in her 60s and will continue receiving RMDs, which she understands will be taxable to her. However, she is still working and she would like the IRA trustee to set up automatic deposits of the RMDs into her own IRA. If so, would she end up paying tax twice on the amount? Or could she treat each deposit as a deductible contribution or nondeductible contribution that increases her basis in the IRA?

A. There are two restrictions against taking the type of action your client is proposing:

First, a required minimum distribution is *not* an eligible rollover distribution. A rollover contribution of an RMD would be considered an excess contribution, subject to the 6% excise tax.

Second, a non-spouse beneficiary may not treat the inherited IRA as her own IRA. This means she can't make additional contributions to the inherited IRA and she cannot rollover amounts to or from the inherited IRA. (There is an exception for a rollover to another inherited IRA set up in the name of the same decedent for the same beneficiary.)

Since your client's brother died after his required beginning date and she is younger than he was, RMDs should be figured over her life expectancy (Table 1, Single Life Expectancy in Appendix B of Pub. 590-B). Distributions must begin by December 31 of the year following the year of the IRA owner's death. See "IRA beneficiaries" in IRS Pub. 590-B, *Distributions from IRAs*.

Even without these restrictions, it would not be a good practice for your client to have automatic transfers from one IRA to the other. Her interest in and eligibility for IRA contributions will likely change over the years. For example, if she no longer has earned income in a future year, she will be ineligible to make an IRA contribution.

It is best to prevent potential issues by depositing RMDs in a non-retirement account, such as a checking or savings account. If she wishes to, she can then withdraw funds from that account and make contributions to an IRA with the non-retirement account merely serving as an available source of funds for her. In other words, as long as she's eligible to do so, she may continue to make contributions to a traditional IRA, deductible or otherwise, or to a Roth IRA, but *not* through direct transfers of RMDs from the inherited IRA.

SEPTEMBER 12, 2018

Q. My client, who is a citizen of Mexico, accepted a research position in a hospital here in North Carolina in 2016. Her husband and two children live in Mexico and they have ITINs. They made the necessary elections to be treated as residents for 2016. They filed joint returns in 2016 and 2017 and claimed exemptions for the children. She knows that in 2018 she will not be able to claim exemptions and the children won't qualify for the new $500 credit. Since there is no benefit for any of her family members and she'll be the only one on the return, should she change her filing status to single, head of household, or MFS for 2018? She will probably be in the U.S. a few more years. The family members visit each other as often as possible but her husband and children will remain in Mexico.

A. Your client should continue to file MFJ or, if it is more advantageous, MFS.

Although there are no tax benefits available for your client's family members, she is still married to her husband and cannot use the single filing status. In rare situations, U.S. residents married to nonresident aliens can be considered unmarried for head of household filing purposes only, but still require a qualifying person to use that filing status. Given your client's circumstances, she does not share the same abode with her family members and so does not have a qualifying person for head of household filing status.

Even without exemptions, MFJ is probably still the most advantageous filing status for your client because of its favorable tax brackets. However, results for MFJ and MFS should be compared. For instance, as MFJ filers, they'll need to consider her husband's worldwide income and eligibility for the foreign earned income exclusion if these are applicable. On the other hand, if your client plans to claim certain credits, such as the lifetime learning credit, she won't be able to do so if she files MFS.

SEPTEMBER 19, 2018

Q. My client has been living with his fiancé and her daughter for a few years. He is not the child's father. His fiancé has no income and no reason to file a tax return; he is their sole support. In prior years, he claimed

dependent exemptions for the two of them. His 2018 income will be around $45,000. Will he be eligible for the new $500 credit? Can he now file as head of household and claim other tax benefits?

A. Your client is eligible for the $500 credit for other dependents, but not for any other dependent-connected tax benefits.

Under the TCJA, the new §24(h)(4) credit for other dependents is available to a taxpayer who has a qualifying child (who is ineligible for the child tax credit) or a qualifying relative. In this situation, it appears your client's fiancé and her daughter are qualifying relatives under §152(d)(2)(H). That is, they are not related to him but are members of his household the entire year and presumably meet the other qualifying relative tests. While the daughter is potentially a qualifying child of her mother, since the mother has no return filing requirement and doesn't file a return, she is not a "taxpayer" and the daughter is not treated as her qualifying child.

Given these facts, your client may claim the $500 credit for each of his dependents. Note that the credit for other dependents is subject to paid preparer due diligence requirements.

Otherwise, there are no changes to dependent-connected tax benefits that impact your client. As under prior law, head of household filing status is not available if the taxpayer's only dependent is an unrelated individual who is a member of the taxpayer's household. This restriction has not changed under the TCJA. Your client cannot claim the EITC or CTC because these tax benefits require a qualifying child.

SEPTEMBER 26, 2018

Q. Our clients sustained considerable damage to their main home last June because of storms and flooding in their town. Their home is in Cameron County, Texas, which was declared a major disaster area. Unfortunately for them, they've had a very difficult year. In addition to the flood, earlier in 2018, a fire at their vacation home damaged part of the house and completely ruined the car they keep there. We've done some preliminary calculations of their losses, taking insurance into account. It appears they'll have casualty losses for their main home and for the car. However, they will probably have a gain for the vacation home. How does the new law affect their casualty losses? Since they can't deduct the loss on the car, are they stuck with paying tax on the insurance gain on their vacation home?

A. Your clients may use the casualty loss on their car to offset the casualty gain stemming from the vacation home fire. If there is any remaining personal casualty gain it will be applied to the casualty loss on their main home stemming from the flood.

The TCJA modified §165(h) for tax years 2018 through 2025, limiting personal casualty loss deductions to losses sustained in a federally declared disaster area on account of the disaster. The loss to your clients' car, by itself, is a nondeductible loss because it is a personal casualty loss and not related to a federal disaster.

However, §165(h)(5)(B) carves out an exception for personal casualty gains. Under this exception, personal casualty losses, both deductible and non-deductible, may be used to offset personal casualty gains. Under an ordering rule in the law, the loss due to the fire (the nondeductible loss) would offset the gain first and then the loss due to the flood (the deductible loss) would offset any remaining gain.

To illustrate, say that the main home loss due to the flood is $25,000, the car loss is $8,000, and the vacation home gain is $10,000. Your clients would first offset the car loss by the vacation home gain, leaving $2,000 excess gain ($8,000 - $10,000) to offset the flood loss, bringing the deductible flood loss down to $23,000 ($25,000 - $2,000). Now suppose the car loss was $10,000 and the vacation home gain was only $8,000. In that case, your clients would have a $2,000 nondeductible loss on the car.