Questions of the Week

Topics Covered October-December 2018

October 10, 2018: **Wristwatch with heart monitoring functions.** Clients have been asking about the newest Apple watch, which has built in heart-monitoring functions, as well as other new functions that are not related to heart or health issues. If a client has or is at risk for developing a heart condition and has a doctor's prescription for the watch, could the client pay for it with HSA funds?

October 17, 2018: **Tax implications of Solar Renewable Energy Certificates.** A naturalized citizen inherited a condominium in a foreign country. He isn't quite sure what he'll do with it. If he decides to rent it out for a few years, must he depreciate the property using ADS and a 40-year recovery period?

October 24, 2018: **Impairment-related work expenses.** A visually impaired client purchased special equipment which she needs in order to do work. Since employee business expenses are no longer deductible, is there any way for her to deduct this expense? She would not be able to do her job without this equipment.

November 7, 2018: **Using home equity loan to purchase a second home.** A client wants to buy a vacation home. Rather than securing a mortgage for that home, he wants to purchase it with a home equity loan on his primary residence because that's "easier." Since the loan would be used to buy a second home and he's still under the $750,000 mortgage limit would he be able to deduct the interest on the home equity loan?

November 14, 2018: **Rental condo sold for less than purchase price but more than FMV when first converted from personal use.** 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?

November 28, 2018: **Tax ID (SSN/ITIN) requirements for tax credits.** The various credits for dependents all seem to have different tax ID requirements. How do the EIC, child tax credit, and the credit for other dependents differ in terms of these requirements?

December 5, 2018: **Child tax credit and credit for other dependents under the TCJA**. In the past, our clients have been unable to claim the child tax credit because of their high AGI, but it looks like they may be able to do so in 2018. They have two children under age 17 and one child who is a college student. Will they be able to claim the child tax credit or the new credit for other dependents in 2018? If so, how are these credits calculated with the new phaseout formula?

December 12, 2018: **Long-term capital gain and the 0% rate**. A client realized $20,000 in long-term capital gain from a stock sale. Since this amount is well under the 12% bracket for his filing status, is it still taxed at 0%? He also has wages of about $75,000.

December 19, 2018: **Food served during an entertainment venue**. A business client often brings customers to sporting events. Under what circumstances can he deduct the cost of meals? Is it only if they eat out before or after a game, or can he deduct the cost of meals at the game, such as food served in a baseball suite?

December 26, 2018: **Effect of excluded forgiven debt on EIC calculation.** A divorced taxpayer with a young child would otherwise be eligible for the EIC but for $15,000 in forgiven credit card debt. She is insolvent and none of the cancelled debt will be taxable. The $15,000 would reduce or eliminate her EIC. Will the cancelled debt affect her EIC calculation?

October 10, 2018

Q. Clients have been asking us about the newest Apple Watch. They say it includes a built-in electrocardiograph and can detect heart-related conditions and that these new features have been FDA-approved. If a doctor prescribes the watch for monitoring and detecting heart conditions for people at high risk of developing them, could the watch be a qualified medical expense for their HSAs? Of course, the watch has many other functions that are not related to heart or other health issues.

A. The cost of the new Apple watch, by itself, is not a qualified medical expense. The incremental cost of monitoring heart functions may be a qualified medical expense in limited circumstances.

Qualified medical expenses for HSA purposes (§223) generally follow the same guidelines as those for itemized deduction (§213) purposes. This includes the cost of "medical care," defined in part as costs paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body.

The cost of medical equipment may meet this definition, whereas the cost of an item ordinarily used for personal, living, or family purposes generally would not unless it can be clearly established that it is used *primarily* to prevent or alleviate a physical disability or illness.

Although it has many new capabilities related to health, the Apple watch is a personal use item and its cost would not qualify as a medical expense. While one of its new functions is a device for detecting atrial fibrillation and taking an electrocardiogram (ECG), the line between personal use item and medical device is not as clear and will depend on each individual's facts and circumstances.

If a client has a doctor's prescription and the facts and circumstances support the medical need of the mobile ECG device, then the incremental cost, which may include an additional cost for the app, an upgrade, or a monthly subscription may be a medical expense for HSA or itemized deduction purposes. Note that a client that is simply interested in the various health monitoring functions could not treat the cost as a medical expense.

The client must have a diagnosed medical condition and a doctor's prescription for this particular device, not merely a recommendation for the watch.

Also, it is quite likely that clients with heart and other serious medical conditions requiring regular monitoring already have FDA-approved devices to do so. Such devices may be far less expensive than the watch and may be covered by insurance. Many heart monitoring functions on the new watch may not yet be available or may only have FDA "clearance" rather than approval.

October 17, 2018

Q. My client, who is a naturalized citizen, just found out he has inherited a condominium in a resort area in Italy. At this point, he is not sure what he wants to do with the property and is investigating several options, including the possibility of renting it for a few years. We've had discussions about reporting rental income and expenses if he decides to go that route. Is he required to use ADS and depreciate the property over 40 years?

A. Because this is a foreign rental property, your client is required to use the alternative depreciation system (ADS). However, the TCJA lowered the ADS recovery period for residential rental property to 30 years. The shorter period applies to property placed in service after December 31, 2017.

For property placed in service before January 1, 2018, the 40-year recovery period still applies. However, the 30-year recovery period can be applied to improvements made to foreign residential rental properties, such as adding a room or putting on a new roof. There is no change to the ADS 40-year recovery period requirement for foreign nonresidential rental properties.

If your client decides to rent out the condominium, he should also be mindful of possible foreign financial reporting obligations, such as FinCEN Form 114, *Report of Foreign Bank and Financial Accounts (FBAR)* and Form 8938, *Statement of Specified Foreign Financial Assets*. For instance, he would need to file the FBAR if he keeps a bank account in Italy to handle rent deposits and pay bills and the bank balance is more than $10,000 at any time during the year. See Comparison of Form 8938 and FBAR Requirements.

October 24, 2018

Q. We have a new client who is visually impaired. She is considered legally blind and requires assistance in order to do her job. She purchased a special monitor and screen-reader software, which she explained is a program that converts text to speech. Since employee business expenses are no longer deductible, is there any way for her to deduct this expense?

A. Yes, assuming your client will itemize deductions in 2018, she can deduct the items you mentioned.

The TCJA eliminated all miscellaneous itemized deductions that are subject to the 2% of AGI floor, including employee business expenses. However, several miscellaneous deductions that are *not* subject to the 2% limitation were not eliminated by the TCJA. One of these is impairment-related work expenses. The individual must have a physical or mental disability which limits employment or other life activities. Impairment-related work expenses are ordinary and necessary business expenses connected with the individual's place of work and which enable the individual to work.

See "Impairment-Related Work Expenses" in IRS Pub. 529, *Miscellaneous Deductions*. For 2018, impairment-related work expenses are reported on Form 2106, *Employee Business Expenses*, and line 16 of Schedule A. Note that if your client does not have sufficient itemized deductions to exceed the standard deduction, the expense cannot be deducted anywhere else on the tax return. Expenses of Armed Forces reservists, performing artists, and certain government officials (the only other taxpayers who may deduct employee business expenses) report these expenses as an adjustment to income.

November 7, 2018

Q. A client called to say he is considering buying a small lake home that they'll use for long weekends, vacations, etc. and possibly for retirement in the future. To buy it, he is thinking of taking out a home equity loan on his primary residence because "that will just be easier than getting a mortgage on the new home." Will he be able to deduct the interest on the home equity loan? It would be used to buy a secondary residence and he is still well under the new $750,000 mortgage limitation.

A. Your client would not be able to deduct the interest on the home equity loan if he uses it to buy the lake home.

The IRS addressed this situation in IR-2018-32. Under this guidance, interest is deductible if all three of the following criteria are met:

- Loan proceeds are used to buy, build, or substantially improve the taxpayer's qualified residence.
- The loan is secured by the qualified residence and does not exceed the cost of the residence.
- The taxpayer has not exceeded the new dollar limitation for new qualified residence loans.

Taken together, the first and second points mean that a loan used to buy a qualified residence must be secured by the *same* qualified residence.

IR-2018-32, Example 2 discusses a situation in which a taxpayer takes out a loan to buy a primary residence and the loan is secured by that residence. The taxpayer then takes out another loan to buy a vacation home and this loan is secured by the vacation home. Since each loan is secured by its respective qualified residence, and assuming dollar limits are not exceeded, the interest on both loans is deductible.

The example goes on to explain that if the taxpayer had instead taken out a second loan secured by the primary residence but used to buy the vacation home, the interest on that second loan would be nondeductible because it is not secured by the vacation home. Also, it would not matter if the second loan was called a home equity loan, second mortgage, etc. – the point is that it would have to be secured by the vacation home in order for the interest to be deductible.

Applying these principles to your client's situation, although his lake home would also be a qualified residence, if he buys it with a loan secured by his main home the interest would not be deductible. Even though it might involve a longer process, if your client itemizes deductions and wants to deduct the interest on money borrowed to buy the new home, the loan must be secured by that home.

November 14, 2018

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.

November 28, 2018

Q. After tax reform, the various credits for dependents all seem to have different tax ID requirements. How do the EIC, child tax credit, and the new $500 other dependent credit differ in terms of tax ID (SSN or ITIN) requirements?

A. Prior to the TCJA, only the earned income credit had a social security number (SSN) requirement. Here, the SSN must be valid for work in the U.S. An SSN issued solely to obtain federally funded benefits and that says "not valid for employment" on the card does not serve as a valid SSN for the earned income credit. The TCJA now has an SSN requirement for the child tax credit as well.

Here is a rundown of the current taxpayer ID requirements for the three types of tax credits.

Earned income credit (EIC): The taxpayer, the taxpayer's spouse if married, and any child claimed for the EIC must have a valid SSN. This provision was in effect before the TCJA and was not affected by the new law. Before the PATH Act of 2015, it was possible to amend returns for open years to claim the EIC for taxpayers with individual tax identification numbers (ITINs) who later received valid SSNs. Because the PATH Act requires the taxpayer, spouse, and qualifying child to have the SSN in place prior to the due date of the return, retroactive claims for EIC are no longer possible.

Child tax credit (CTC): The TCJA added an SSN requirement for CTC claims starting with tax year 2018. The change applies to both the nonrefundable and refundable portions of the credit. Unlike the EIC though, the SSN is required only for the qualifying child. Thus, a taxpayer and spouse may have ITINs but claim the CTC for a child with an SSN. The SSN must be valid for work and must be in place by the due date of the return.

Because SSNs must be applied for with the Social Security Administration rather than submitting a W-7 application with the tax return, taxpayers who expect to receive an SSN for their child after the return due date should consider requesting an extension. If the SSN is received by the extended due date, the taxpayer can then file claiming the CTC / ACTC. Otherwise, the taxpayer will have to wait until the following tax year to claim the CTC.

If a child obtains an SSN in 2018 or later, tax returns for 2017 and earlier cannot routinely claim the CTC even though the SSN requirement didn't apply before 2018. For example, if a qualifying child had an ITIN prior to the due date of the 2017 return and a return was not filed or filed without claiming the CTC, an original or amended return can be filed for 2017 to claim the credit. If the child did not have an ITIN by the return due date, the credit can't be claimed for 2017. In other words, the relevant ID number requirement must be met each year.

Credit for other dependents (ODC): The new $500 credit for other dependents may be claimed for a dependent with an SSN or ITIN. Just as with the other two credits, the dependent must have the tax ID by the due date of the tax return. Also, while the ODC is available for an individual with an ITIN, the qualifying dependent must be a U.S. citizen or a U.S. resident. Non-U.S. citizens/residents who are residents of Canada or Mexico are not qualifying children or qualifying relatives eligible for the ODC.

December 5, 2018

Q. Our clients' 2018 AGI should be about $460,000. In previous years they were not eligible for tax credits because of their high income. They are joint filers with three children, ages 13, 16, and 21 (the 21-year old is in college and will graduate in May 2019). Will they be able to claim the child tax credit or the new credit for other dependents in 2018? How does the phaseout formula work if they're eligible for both credits? At what point would their credit be completely phased out.

A. It appears your clients will be eligible for child tax credits (CTCs) and the credit for other dependents (ODC) in 2018.

Under the TCJA, the maximum CTC was increased from $1,000 to $2,000 per qualifying child and the new $500 ODC was added for dependents who don't qualify for the CTC. Especially relevant to your clients, the MFJ credit phaseout begins at modified AGI of $400,000 (increased from $110,000). The credit is reduced by $50 for each $1,000 (or 5% of the excess) over the phaseout threshold. The phaseout is applied to the total credit, that is, the sum of all CTCs and ODCs the client is eligible to claim.

Applying this information to your clients, they have two qualifying children under 17 and one qualifying child who is over 18 and a student. Their total credit before considering the phaseout is therefore $4,500 [($2,000 CTC × 2) + $500 ODC].

The phaseout reduction is $3,000 [($460,000 AGI - $400,000 MFJ phaseout threshold) × 5%]. The resulting potential credit is $1,500 ($4,500 total credit - $3,000 phaseout amount).

Note that next year your clients will probably not be able to claim the CTC/ODC given the same AGI. That is because their second child will turn 17 and thus will be eligible for the ODC rather than the CTC. If their oldest child is no longer a dependent after graduation, the maximum credit before phaseout will be only $2,500 ($2,000 CTC + $500 ODC) which is less than the phaseout amount. To determine the ending AGI for the credit, divide the total maximum credit by 5% and add the result to the phaseout threshold. In this example, the result would be $450,000 [($2,500 total credit ÷ 5%) + $400,000]. That would mean your clients would need AGI to be less than $450,000 next year to claim the credit.

Forms update: Form 1040 and Instructions for tax year 2018 have been finalized by the IRS. The 2018 Form 1040 Instructions contain a Child Tax Credit and Credit for Other Dependents Worksheet (pp 42-43) that is used to calculate the allowable credit. The 2018 Form 1040 shows the combined child tax credit/credit for other dependents claimed on line 12a of Form 1040. Taxpayers who qualify for the additional child tax credit will continue to calculate the refundable portion of the credit on Schedule 8812.

December 12, 2018

Q. A client has a large long-term capital gain – about $20,000 – from the sale of stock. He also has wages of about $75,000. Since the capital gain is well under the 12% bracket, is it taxed at 0%? The client is single and doesn't itemize deductions. He has no other income for 2018.

A. Your client's long-term capital gain (LTCG) will be taxed at 15% rather than 10% (or 0%) because his taxable income is over the breakpoint for the 15% net capital gain rate.

Before 2018, an individual's net capital gain was taxed at 0% to the extent the individual's taxable income was in the lowest two tax brackets (10% and 15%). For those with taxable income in the highest tax bracket, 39.6%, the net capital gain rate was 20%.

Under the TCJA, the 0% / 15% / 20% net capital gain rates are preserved but the thresholds, or breakpoints, for those rates are no longer based on the ordinary tax brackets:

Ordinary income rates and brackets (Single taxpayers – 2018)

10% - taxable income $0-$9,525

12% - taxable income $9,526-$38,700

22% - taxable income $38,701-$82,500

24% - taxable income $82,501-$157,500

32% - taxable income $157,501-$200,000

35% - taxable income $200,001-$500,000

37% - taxable income over $500,000

Net capital gain rates (Single taxpayers – 2018)

0% - taxable income $0-$38,600

15% - taxable income $38,601-$425,800

20% - taxable income over $425,800

Although the net capital gain breakpoints no longer mesh with ordinary tax brackets, the concept is the same: an individual's long-term capital gain is taxed at 0% only to the extent that the individual's taxable income is no more than $38,600. Applying this principal to your client's situation, his taxable income is $83,000 ($75,000 wages + $20,000 LTCG - $12,000 standard deduction). Since $83,000 is well over the 15% breakpoint ($38,601), his LTCG is taxed at 15%. Note that the calculation is a bit more complicated if taxable income straddles one of the breakpoints.

In this case, your client's total tax will be $12,805:

$9,805 tax on $63,000 ($83,000 - $20,000) ordinary taxable income taxed at ordinary rates
$3,000 tax on $20,000 LTCG taxed at 15%
$12,805 total tax

If your client's total taxable income had been $38,600 or less, the $20,000 would have been taxed at 0%. And if total taxable income had been over $425,800 it would have been taxed at 20%.

For the breakpoints for other filing statuses, see "Capital Gains Rates" in the Tax Research Center.

December 19, 2018

Q. A business client frequently brings customers and potential customers to sporting events. We know that entertainment expenses are no longer deductible, but what about food? Is the meal deductible only if they eat in a restaurant before or after the game, or is it possible to deduct the meal expense if they eat at the game? For instance, he has baseball suite tickets and they usually have food served at the game.

A. The IRS addressed this very situation in Notice 2018-76. Under the guidance in this notice, a taxpayer may deduct 50% of business meal costs if *all* of the following are true:

1. The expense is an ordinary and necessary business expense paid or incurred during the taxpayer's taxable year.
2. The expense is not lavish or extravagant under the applicable facts and circumstances.
3. The taxpayer, or an employee of the taxpayer, is present when the food or beverages are furnished.
4. The food and beverages are provided to a current or potential business customer, client, consultant, or other business contact.
5. When food and beverages are provided as part of an entertainment activity, the food and beverages are purchased separately from the entertainment or the cost is stated separately from the entertainment costs on bills, invoices, receipts, etc.

The first four criteria are the general requirements for deducting business meals. The fifth takes care of the TCJA change disallowing entertainment expenses but continuing to allow qualified business meal expenses. If the fifth requirement is not met, food and beverage costs are treated as nondeductible entertainment expenses rather than deductible business meals. Entertainment activities may include going to a night club, theater, sporting event, etc.

Applying this principle to your client's situation, if he purchases food separately, or the facility bills or separately states the cost of food and beverages on the billing for the suite tickets, then your client may deduct 50% of the business meal cost, assuming all of the other criteria are met. Otherwise, the cost of food and beverages is treated as part of nondeductible entertainment expenses.

Notice 2018-76 is transitional guidance that taxpayers may rely on until the Treasury Department and IRS publish proposed regulations on §274 as amended by the TCJA.

December 26, 2018

Q. A client received Form 1099-C for cancellation of debt. The amount is about $15,000, mostly stemming from credit card debt incurred while she was going through a divorce. Although she is getting back on her feet, she is still insolvent and none of the forgiven debt will be taxable. She has a small child and is eligible for the EIC, but the $15,000 would reduce or eliminate her credit. Will the cancelled debt affect her EIC calculation?

A. Income qualifying for the discharge of indebtedness insolvency exclusion does not affect the earned income credit. Under §32(a)(2), the EIC phaseout is based on the greater of earned income or adjusted gross income, but *not* on modified adjusted gross income. In other words, there is no requirement in the current law to add back any type of non-taxable or excluded income or any adjustments to AGI. Note that taxpayers who claim the foreign earned income exclusion are ineligible for EIC.

If your client is able to exclude all of the cancelled debt, then her EIC calculation will not be affected, assuming she otherwise qualifies for the credit. If she can exclude only part of the debt, then the taxable part will figure into AGI and potentially reduce the credit. Be sure to complete Form 982 (draft 3/6/18), *Reduction of Tax Attributes Due to Discharge of Indebtedness*, and the Insolvency Worksheet, which can be found in IRS Pub. 4681, *Cancelled Debts, Foreclosures, Repossessions, and Abandonments*.