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TAX in the News

Tax Information for Tax Practitioners

May 22, 2019

Upcoming free IRS webinars in June; two hours of continuing education available for participation in *each* webinar

- **Foreign Earned Income Exclusion**; Thursday June 6, 2019 at 2:00 PM ET. Registration.
- **U.S. Taxation of Employees of Foreign Governments and International Organizations**; Thursday June 13, 2019 at 2:00 PM ET. Registration.
- **U.S. Territories – Self-Employment Tax**

  English, Wednesday June 19, 2019 at 2:00 PM ET. Registration.

  Spanish, Thursday June 20, 2019 at 2:00 PM ET. Registration.
- **Determining Tax Residency Status**; Thursday June 27 at 2:00 PM ET. Registration.

TAX NEWS

Tax Court Rules IRS Cannot Reclassify Medicaid Waiver Payments to Deny Taxpayers' EITC and ACTC—Medicaid waiver payments are state payments made to a caregiver for home-based support services for an eligible individual, such as a disabled child. IRS guidance in Notice 2014-7 provides that such payments may be treated as excludable difficulty of care payments, a type of foster care payment for the care of individuals with special needs who are placed in family homes. In the *Feigh* case, the Tax Court ruled against the IRS's position that taxpayers who excluded their Medicaid waiver payments as per Notice 2014-7 could not treat the payments as earned income for refundable credit purposes.

The Tax Court concluded that the IRS could not use this notice to deprive the taxpayers of tax benefits bestowed by Congress. Although the Tax Court challenged the IRS's reasoning in Notice 2014-7 and allowed the Feighs to claim the EITC and ACTC, the court did *not* expressly state that taxpayers cannot exclude Medicaid waiver payments. We expect further guidance on this decision and will keep you apprised of developments. Page 3

IRS Posts Correction to Schedule D Worksheet; No Action Needed at This Time for Potentially Impacted Taxpayers—The IRS advises that the worksheet to Schedule D for Forms 1040 and 1041 contained an error, namely that the worksheet did not work correctly with the new TCJA regular tax rates and brackets for some filers. The error, which has been fixed, may impact taxpayers who filed before May 16 and had collectibles gain and/or unrecaptured §1250 gain on the sale of a rental property. According to the post, the IRS is reviewing returns filed before the correction was made and will communicate regarding any corrective action needed. Page 4

QUESTION OF THE WEEK

Clients refinanced their mortgage in 2018. They used some of the funds to remodel their kitchen and the rest to pay off their old loan. They also paid points to get a better rate. Are the points deductible on their 2018 return? Page 5

ORIGINAL INSIGHTS

The Tax Benefits of Tidying Up Through Noncash Charitable Contributions— Based on Marie Kondo's decluttering method and Netflix show, people are donating their belongings, but how does donating noncash items save money on taxes? Full insight. View all insights at www.thetaxinstitute.com/insights/.

TAX COURT RULES IRS CANNOT RECLASSIFY MEDICAID WAIVER PAYMENTS TO DENY TAXPAYERS' EITC AND ACTC

Court case: Feigh v. Comm'r, 152 T.C. No. 15, May 15, 2019

The Tax Court held that the IRS cannot reclassify Medicaid waiver payments as excludable foster care payments in order to remove tax benefits provided by Congress, namely the EITC and ACTC.

Background

Mary Feigh received a Form W-2 for tax year 2015 showing $7,353 from "MAINSL SERVICES MN." The amount represented a Minnesota Medicaid waiver payment for the care of her adult disabled children.

Mary and her spouse reported the wages on their joint tax return for 2015 but excluded the payment from gross income following IRS's guidance in Notice 2014-7 regarding Medicaid waiver payments. The Feighs also claimed EITC of $3,319 and an ACTC of $653 based on the Medicaid waiver payment.

The IRS denied the EITC and ACTC because under Notice 2014-7, the excludable Medicaid waiver payment is not earned income for purposes of the two refundable credits.

Law and discussion

IRS's 2014 guidance. A Medicaid waiver payment is a payment made by a state to a caregiver for providing home-based support services to an eligible individual, such as a disabled child or elderly parent. The idea is to provide suitable personal care so that the individual need not be institutionalized. In 2014, the IRS issued Notice 2014-7 and related FAQs advising that Medicaid waiver payments received by individual care providers will be treated as excludable §131(c) difficulty of care payments, even if the provider is related to the care recipient.

A difficulty of care payment is a type of foster care payment made when the state determines that a foster placement requires specialized care because of the individual's physical, mental, or emotional handicap. Difficulty of care payments are generally excludable from gross income unless the provider is caring for:

- more than 10 individuals under age 19, or
- more than 5 individuals who are 19 or older.

In Notice 2014-7, the IRS took the position that Medicaid waiver programs and state foster care programs "share similar oversight and purposes." That is, an eligible individual living in the home of a provider who receives Medicaid waiver payments is similar to a foster individual placed in a foster family home of a provider who receives difficulty of care payments because both scenarios prevent institutionalization of the individuals.

The IRS concluded that Medicaid waiver payments made by a state or its authorized agency are excludable from the care provider's gross income (subject to tax if the provider cares for more than the stated number of individuals). The payments must compensate the caregiver for personal care services and habilitation services provided under an approved plan of care for the eligible individual living in the caregiver's home.

Further, under IRS guidance, a caregiver who excludes payments from gross income may not include the payments in the calculation of EITC or other earned income-related tax breaks such as the ACTC.

Earned income is defined in §32(c)(2)(A)(i), for both EITC and ACTC purposes, as "wages, salaries, tips and other employee compensation, but only if such amounts are includible in gross income for the tax year."

The parties' positions. The IRS argued that since the Feighs properly excluded their Medicaid waiver payments from gross income as per Notice 2014-7, and since they did not report any other type of income that would qualify as earned income, they were not eligible for the two refundable credits.

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The Feighs argued that there is no statutory, regulatory, or judicial authority that classifies Medicaid waiver payments as not includable in gross income. The sole authority for the IRS's position is the IRS's own Notice 2014-7. The Feighs said the "IRS cannot, through a subregulatory notice, reclassify their otherwise 'earned income' as unearned for purposes of determining tax credit eligibility."

The sole issue before the court was whether Medicaid waiver payments, which are excludable from gross income as difficulty of care payments under Notice 2014-7, still qualify as earned income for EITC and ACTC eligibility.

The Tax Court's reasoning. The Feighs' Medicaid waiver payments would have been includable in gross income but for Notice 2014-7, so the question for the Tax Court was whether a notice could "effectively usurp Congress' authority in granting tax credits by denying petitioners a credit they would have been entitled to in the absence of the notice." The court placed particular emphasis on the plain meaning of words in the law and found "no compelling rationale" that an individual receiving care in a provider's home under the Medicaid waiver program was equivalent to being "placed" in a foster home for §131 purposes.

Also pointing out that Notice 2014-7 reversed the IRS's historical practice of challenging the excludability of Medicaid waiver payments, the court said that this notice is entitled to little, if any, deference.

Conclusion

The Tax Court held that the IRS cannot use a notice to deprive the Feighs of benefits bestowed by Congress—the EITC and ACTC. The IRS cannot reclassify income as not "earned income" through Notice 2014-7. However, as the IRS did not argue in the alternative that the Feighs should include the payments in gross income, The Tax Court declined to address whether they properly excluded their Medicaid waiver payments from gross income.

Potential impacts

In the instant case, the Feighs were apparently able to claim refundable credits but were not required to pay tax on the Medicaid waiver payments. While the Tax Court challenged the IRS's reasoning and conclusions in Notice 2014-7, it did not explicitly state that the taxpayers could not use its guidance to exclude Medicaid waiver payments.

This decision raises several issues for taxpayers who previously excluded Medicaid waiver payments and also did not claim EITC and/or ACTC because of Notice 2014-7:

- Going forward, can affected taxpayers claim the EITC and/or ACTC if otherwise eligible?
- Going forward, must affected taxpayers now include Medicaid waiver payments in gross income?
- Can affected taxpayers amend prior years' returns to claim EITC / ACTC? Will the IRS require the payments to be included in gross income if so?
- Will congress introduce legislation addressing these issues?
- Will agencies need to issue corrected W-2s for the current or prior tax years?
- If the IRS decides to appeal the decision, what actions are required at this time?

We expect further guidance on this Tax Court decision and will keep you apprised of developments.

IRS POSTS CORRECTION TO SCHEDULE D WORKSHEET; NO ACTION NEEDED AT THIS TIME FOR POTENTIALLY IMPACTED TAXPAYERS

The IRS has posted Error in Tax Calculation in Schedule D Tax Worksheet (Form 1040) to its website. The original Schedule D worksheet did not work correctly with the new TCJA regular tax rates and brackets for certain Schedule D filers.

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The correction applies to:

- Collectibles gain reported on line 18 of Schedule D, taxed at a maximum rate of 28%, or
- Unrecaptured §1250 gain reported on line 19 of Schedule D, taxed at a maximum rate of 25%.

  Note, unrecaptured §1250 gain applies to gain related to allowed or allowable depreciation when a rental property is sold.

The correction results in a lower regular tax for most affected taxpayers but a higher regular tax for some. A taxpayer's regular tax is potentially impacted if:

1. Form 1040, Schedule D, lines 15 and 16 are both more than zero;
2. Schedule D, line 18 or line 19 is more than zero (or both are more than zero);
3. The taxpayer's taxable income is more than $38,600 if single or married filing separately, $51,700 if head of household, or $77,200 if married filing jointly or a qualifying widow(er);
4. Line 15 of the Schedule D Tax Worksheet is not more than line 14 of the Schedule D Tax Worksheet (those lines were not impacted); and
5. Line 18 of the original Schedule D Tax Worksheet (line 18a of the corrected Schedule D Tax Worksheet) is not more than $157,500 ($315,000 if married filing jointly or a qualifying widow(er)).

According to the post, the IRS has provided the worksheet to its tax software partners, so returns filed after May 15 are not affected by the error. Taxpayers who submitted returns prior to May 16 may use the corrected worksheet to recalculate their tax to see if there are any changes. However, these taxpayers do not have to file an amended return. The IRS is reviewing all potentially impacted returns to determine what corrective action is needed.

The same correction and guidance has also been posted for the Form 1041 Schedule D worksheet.

QUESTION OF THE WEEK

Q. Our clients refinanced their mortgage in 2018 to get a better interest rate and to get funds to remodel their kitchen. Their new loan is for $180,000 for a term of 15 years. They used $135,000 of the loan to pay off their old mortgage and $45,000 for their kitchen. They also paid $3,600 out of their own funds for two points and made 6 payments on the new mortgage in 2018. Are the points deductible on their 2018 return?

A. Your clients may be able to deduct a portion of the points related to the home improvement they made. The balance of the points must be deducted ratably over the life of the new loan.

Points paid to refinance a mortgage are generally not deductible. However, if a portion of the loan proceeds is used to substantially improve the home secured by the loan, the points are partly deductible in the current year if all of the following are true:

1. The loan is secured by the taxpayer's main home.
2. Paying points is an established business practice in the area where the loan was made.
3. The points are not more than the points generally charged in that area.
4. The taxpayer uses the cash method of accounting.
5. The points don't represent amounts that are ordinarily separately stated on a settlement statement, such as fees and taxes.
6. The taxpayer provided enough funds at closing to pay the points.

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From your description of your clients' situation, it appears that the points meet all of these requirements but do make sure that is the case. For instance, if one of the points is actually a service fee, it is not deductible at all.

If the requirements are met, your clients can deduct $900 ($3,600 × $45,000/$180,000) for the points attributable to the substantial improvement in 2018.

The remaining $2,700 is deducted ratably over the life of the loan, assuming they itemize deductions in future years. For 2018 then, their total deduction for points is $990 [$900 + ($2,700/180 months × 6 payments)].

Note that if your clients had used the entire refinanced loan to pay off their old mortgage they would have been able to deduct only $120 ($3,600/180 months × 6 payments) in 2018. See "Refinancing" on page 7 of IRS Pub. 936, *Home Mortgage Interest Deduction*.