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TAX in the News

Tax Information for Tax Practitioners

Questions of the Week October-December 2018

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Questions of the Week

Topics Covered April-June, 2019

April 10, 2019: Deceased taxpayer's outstanding tax debt. A divorced client has a joint custody agreement with her ex-spouse. The decree states that he has a right to claim the younger child's exemption until she turns 17. Is the client still required to sign an 8332 to relinquish her claim on this child?

April 17, 2019: Standard deduction for MFS filers. After separating last year, a client and her husband agreed to file MFS and claim the standard deduction. He has contacted her to say he intends to amend his return and itemize deductions. Does that mean the client is required to amend her return and itemize deductions too? Will the IRS assess penalties and interest on the additional taxes she'll owe?

April 24, 2019: HSA catch-up contributions. A 58-year old client is covered under her employer's high-deductible health plan and has an HSA. The plan also covers her husband, who is 58-years old as well. Can she contribute $1,000 catch-up contributions for both of them to her HSA?

May 8, 2019: Organizational costs for single-member LLC. A client who operated her business as a sole proprietorship for a few years decided it would be best to become an LLC. Can she deduct on her Schedule C the various fees she paid to form the LLC?

May 15, 2019: Sale of home exclusion for joint filers. When our clients married in 2018, one of the spouses sold a home she owned prior to the marriage and moved into the other spouse's home. They claimed a $250,000 exclusion on their joint return for 2018. They would now like to sell his home too and buy a new home together. If they sell the home they live in now in 2019, will they qualify for an exclusion and, if so, would it be $250,000 or $500,000?

May 22, 2019: Refinancing points. 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?

May 29, 2019: Disposition of assets after de minimis safe harbor election. A client wants to sell four laptops that he has been using for his business. When he purchased them a few years ago he wrote off the price under the de minimis safe harbor election. If he sells the equipment will his gain be ordinary or capital gain? What if he were to donate the laptops to a charity instead?

June 12, 2019: Disposition of assets after de minimis safe harbor election (follow-up to May 29). Our client would now like to know what would happen if he either sold the laptops or bought them himself and then donated the proceeds to charity. Would he or the business be able to claim a deduction for the charitable contribution?

June 19, 2019: Coordinating education tax benefits. A client withdrew $7,500 from a QTP for his daughter's college expenses. Although her expenses were about the same as the distribution, she also received a small scholarship and the client would like to claim the American opportunity credit too. How does the client coordinate the three tax benefits? Would he have to pay a penalty on part of the QTP distribution?

June 26, 2019: Qualified HSA funding distributions. A client with a traditional IRA wants to do a rollover to an HSA. Is this type of transfer allowed and would it be taxable? How much can she roll over from the IRA to the HSA each year?

April 10, 2019

Q. My client is divorced and has a joint custody agreement with her ex-spouse for their two children. The children live with her in her home for more than half the year (they stay with their father for some holiday weekends, vacations, etc.). Their decree states that he has a right to the younger child's exemption until she turns 17. The decree was signed in 2011. Does the client need to sign an 8332 in order to relinquish her claim for this child?

A. Yes, your client must sign Form 8332, *Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent* if she wants her ex-spouse to claim the child. Without the exemption release, the child's father may not claim her. The tax law does not *require* her to release the exemption, but she should consult her attorney if she doesn't wish to do so.

Even though their decree states they have joint custody, your client *is* the custodial parent. Under the regulations (Reg. §1.152-4(d)), for tax purposes, the custodial parent is "the parent with whom the child resides for the greater number of nights during the calendar year, and the noncustodial parent is the parent who is not the custodial parent." In this situation, the children clearly reside with your client the greater number of nights during the year.

Under the rules for divorced and separated parents (§152(e)), the custodial parent must sign a written declaration "in such manner and form as the Secretary may by regulations prescribe" that she will not claim the child as a dependent. The noncustodial parent must attach the declaration to his return. The regulations (Reg. §1.152-4(e)(3)(ii)) state that Form 8332 is the appropriate form for the release.

Form 8332 is not expressly required by the regulations, but any alternative written declaration must contain all information in the form to accomplish the release:

- The child's name
- The year or years of the release
- An explicit statement that the custodial parent will not claim the child for the stated years
- The custodial parent's signature, SSN, and the date
- The noncustodial parent's name and SSN

Also, the only purpose of the alternative declaration must be for the exemption release.

For most parents, Form 8332 is the best way to effect the release and it is very difficult to produce a satisfactory alternative. Before 2009, the IRS did accept divorce decrees if several requirements were met. One of these was the unconditional release of the child's exemption. Since most decrees include a condition, such as the payment of support, few divorce decrees were acceptable. Decrees executed in 2009 or later may not be used as an alternative declaration, regardless of the language in the decree.

TCJA and the exemption release

Although the exemption amount is $0 for tax years 2018 through 2025, the release allows the noncustodial parent to claim the child tax credit, additional child tax credit, and the credit for other dependents as applicable. The release does not apply to the EITC, child and dependent care credit, or head of household filing status. See "Written declaration" on page 11 of IRS Pub. 504, *Divorced or Separated Individuals*. Back to top

April 17, 2019

Q. My client separated from her husband late in 2018. They did not divorce before the end of the year and neither one qualifies to file as head of household. They did agree, at least verbally, to file separate returns and to claim the standard deduction, which they both did. He just contacted her to say he intends to file an amended return and itemize deductions because it is more beneficial to him. She has very little to itemize, certainly nothing near the $12,000 MFS standard deduction. Is she required to amend her return and itemize? Will she have to pay penalty and interest on the additional tax?

A. Your client does not have to amend her return to itemize deductions if she does not want to and her husband's amended return will not be accepted.

Changes in the election to itemize deductions are covered under §63(e)(3). In general, a taxpayer may amend a return to switch from the standard deduction to itemizing deductions, or the other way around. However, if a married taxpayer files a separate return, the change is not allowed unless 1) the other spouse also changes her election, and 2) both spouses consent, *in writing*, to any additional taxes assessed.

In your client's situation, if she does not agree to amend her return to itemize deductions and pay any additional taxes due, her husband's amended return will not be allowed. Note that the same would hold true if they both had initially itemized deductions and one of them wished to switch to the standard deduction. See "Married persons who filed separate returns" on page 156 of IRS Pub. 17, *Your Federal Income Tax*. Back to top

April 24, 2019

Q. My client and her husband are both 58 years old. She was covered under her employer's high deductible plan for all of 2018. She also has a family HSA. Her husband does not work and is covered under her plan. Can she make a catch-up contribution for her husband in addition to her own for 2018?

A. Your client's husband can make a catch-up contribution, but it must be to his own HSA.

Although the term "family HSA" is frequently used, an HSA, much like an IRA, is an individual account. The amount that can be contributed to the HSA depends, in turn, on the owner's high deductible health plan (HDHP) coverage. If the owner has family HDHP coverage all year, which appears to be the case with your client, she can make the maximum contribution, which is $6,900 for 2018. In addition, since she is at least age 55, she can make a catch-up contribution of up to $1,000.

Under the HSA rules, if one spouse has family-HDHP coverage, both spouses are considered to have it. This is so even if the other spouse actually has family coverage, or self-only coverage, or is not covered under a separate health plan. Assuming he does not have any disqualifying coverage, your client's husband is an eligible individual because he is covered under her HDHP.

In order to make a catch-up contribution, he must set up his own HSA. Their maximum contribution for 2018 is $8,900 ($6,900 + $1,000 + $1,000) since they're both eligible individuals. They may divide the family contribution (up to $6,900) equally between the two HSAs or split it any way they like. However, the additional contribution for age may only be made to each respective spouse's account. For example, they could put a total of $7,900 in her HSA and only the $1,000 catch-up contribution in his HSA. See "Rules for Married People" on page 6 of IRS Pub. 969, *Health Savings Accounts and Other Tax-Advantaged Health Plans*.

Even if your client's husband was not an eligible individual, or even if your client had self-only coverage instead of family coverage, she may still use her HSA funds to pay qualifying medical expenses for both of them. Back to top

May 8, 2019

Q. A client had been operating her interior decorating business as a sole proprietorship for a few years, but last year decided to form an LLC. She paid $800 in legal fees for the articles of organization and another $300 in state filing fees. Can she deduct the $1,100 on her Schedule C?

A. Yes, your client may deduct organizational costs in the amount stated.

Organizational costs include legal fees, registration fees, and related fees to form an entity. Generally, a corporation or partnership may deduct up to $5,000 in organizational costs. The deduction phases out if organizational costs exceed $50,000 and any excess costs are amortized ratably over 15 years.

A special rule applies if the entity is a single member LLC, which is the case with your client. That is because disregarded entities (which includes single member LLCs) must capitalize organizational costs. However, a de minimis exception allows the single member LLC to deduct the expenses if total organizational costs do not exceed $5,000. The LLC makes an election to deduct these costs just by doing so—a separate election statement is not required. If organizational costs exceed $5,000, the single member LLC may not deduct or amortize the costs. They will become deductible only on the entity's dissolution or termination.

See "*How are organizational costs expensed?*" in the Tax Research Center. Back to top

May 15, 2019

Q. Two single clients married in 2018. Each owned a home for several years before they married. After the marriage, one spouse sold her home and moved into the other's home. On their 2018 joint return, they claimed an exclusion, but it was only for $250,000 as he did not meet the ownership or residence requirements. Now they are planning to sell his home some time in 2019 and buy another home together. Will they qualify for an exclusion on their 2019 return for the sale of his home? If so, is the exclusion $250,000 or $500,000?

A. Your clients may claim the §121 exclusion for the residence sale in 2019. The maximum exclusion will be $250,000.

To qualify for the maximum $500,000 exclusion for married couples filing jointly, only one spouse must meet the ownership requirement. However, both spouses must meet the residence requirement. In this situation, while it appears that the ownership requirement has been met, the residence test is an issue because the spouse who moved into the home when the couple married in 2018 has not lived in it for two years. Another issue is that the spouse who moved into the home sold her own home during the two-year "look back" period, so she is not yet eligible for a second exclusion.

Thus, the couple does not qualify for the $500,000 exclusion. The spouse who is now selling his home would qualify for the maximum $250,000 exclusion if he were single. That is, he meets the ownership, residence, and look-back requirements. See "Finding Your Exclusion Limit" on p. 7 of Pub. 523, *Selling Your Home*.

Your clients can claim a maximum exclusion of $250,000 on their joint return if they sell the home in 2019. If your clients decide to wait until the residence and look-back requirements are met for both of them, they potentially qualify for the full $500,000 exclusion at that time. Back to top

May 22, 2019

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.

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*. Back to top

May 29, 2019

Q. In 2017, a small business client purchased four laptops for his company, ranging in price from $400 to $750. He made the de minimis safe harbor election to expense the laptops on his 2017 Schedule C. His business has been doing well and he'd like to replace the laptops with better quality (and more expensive) equipment. He has checked around and can probably sell the laptops for $200 to $300 in total for the four of them. What are the tax consequences of selling the laptops? Is the gain ordinary or capital gain? What if he gives the laptops to a charity instead?

A. If your client decides to sell the laptops, gain on the sale will be ordinary income.

Because of the expensing his basis in the property is $0 so, depending on the sales price, he would recognize $200 to $300 of ordinary income on the sale. The sale is reported on line 10 of Form 4797, *Sales of Business Property*. See "Property deducted under the de minimis safe harbor for tangible property" on page 27 of IRS Pub. 544, *Sales and Other Dispositions of Assets* and the Form 4797 instructions.

Property that is expensed under the de minimis safe harbor election for tangible property is covered under the regulations (Reg. §1.263(a)-1(f))). When the property is sold or disposed of, it is *not* treated as a §1221 capital asset or as §1231 business property. Gain on the sale or disposition is ordinary, rather than capital gain.

If your client decides instead to donate the equipment to a qualified charity, he would not have to recognize any gain. However, he would not be able to deduct the contribution or, more precisely, his deduction would be $0. When ordinary income property is donated, the FMV of the contribution is reduced by the amount that would be ordinary income if the property were sold. For instance, if the property has a FMV of $300, the contribution would be reduced to $0 by the $300 of ordinary income that would be recognized if the property had been sold instead of donated. Back to top

June 12, 2019

Note: This is a follow-up to the QOTW of May 29, 2019

Q. We spoke with our client who is thinking of selling or donating his old laptops. We explained that because he previously made the de minimis safe harbor election to expense the cost of the laptops, gain on a sale would be ordinary gain and his basis would be $0 for charitable contribution purposes. The client would now like to know what would happen if the business sold the laptops and then donated the proceeds to charity. Would the business be able to claim a deduction for the donation in that case? Or, if he bought the laptops himself and then made a personal donation would he be able to claim the contribution on Schedule A?

A. Any sale of the laptops and subsequent donation of the proceeds to charity (as opposed to donating the laptops to charity) would involve two separate and unrelated transactions, a sale and a cash contribution.

As explained previously, the sale would result in ordinary gain to the business, whether the laptops are sold to a third party or your client buys them himself. If your client buys the laptops himself, he should make sure to document how he arrived at the sales price and to record the sale in the company's records.

In general, a sole proprietorship cannot claim a deduction for a charitable contribution. The business may be able to deduct an amount paid to a charitable organization if the payment is made for a business reason. For example, a part or all of a donation made to advertise in the organization's publication may be an advertising expense rather than a charitable contribution. See "charitable contributions" in IRS Pub. 535, *Business Expenses*.

Otherwise, if your client itemizes deductions, he can deduct on Schedule A charitable contributions made by the business or that he makes personally. The fact that the cash donation is made from sale proceeds has no bearing on the deductibility of the contribution. Note however that if there is no business purpose for the contribution and thus no Schedule C deduction *and* your client does not itemize deductions there will be no tax benefit to the contribution. Back to top

June 19, 2019

Q. My client withdrew $7,500 from a QTP for his daughter's college expenses for the fall semester. The 1099-Q shows $800 of the distribution as earnings in box 2. About $5,000 of the expense was for tuition and the rest went for room and board. She also received a small ($500) tax-free scholarship. He would like to claim the maximum American opportunity credit too but isn't sure it's "worth it." How does he coordinate the three education benefits? Would he have to pay a penalty on any taxable distribution?

A. First, he needs to reduce qualified education expenses by the tax-free scholarship, which results in $7,000 ($7,500 - $500) of adjusted qualified education expenses (AQEE). Next, he would further reduce AQEE by $4,000, the maximum tuition that can be used to claim the American opportunity credit. The remaining AQEE for QTP purposes is $3,000.

Since AQEE for QTP purposes is less than the QTP distribution, some of the QTP earnings will be taxable.

To determine the taxable part of the earnings, multiply the earnings by a fraction. The fraction is AQEE over the distribution amount. Subtract the taxable amount from the earnings.

$800 earnings × $3,000 AQEE / $7,500 distribution = $320 tax-free earnings

$800 earnings - $320 = $480 taxable earnings.

Note that your client's daughter (not your client) must include the $480 in gross income. There is no penalty on a taxable QTP distribution if qualified education expenses are adjusted for tax-free scholarships or to claim education credits.

As for your client's question about whether the credit is "worth it," the tax advantage of the $2,500 American opportunity credit for him likely outweighs the tax his daughter would have to pay, if any, on the taxable distribution.

However, her unique tax situation should be considered before he makes the decision to claim the credit. For instance, she is probably subject to the kiddie tax, assuming she was under 24 and did not provide over half of her support from earned income. The taxable earnings are unearned income for her, which could be a problem if she also had a large amount of other types of unearned income. Your client and his daughter should be aware of the kiddie tax possibilities so that they can avoid unexpected tax consequences.

See "Figuring the Taxable Portion of a Distribution" on page 52 of IRS Pub. 970, *Tax Benefits for Education*.
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June 26, 2019

Q. A client has a traditional IRA and would like to roll over some of the funds to an HSA. Can she make rollovers like this and, if so, would the rollovers be taxable (like a rollover to a Roth IRA)? How much can she move from her IRA to the HSA each year?

A. The type of rollover your client is referring to is called a “qualified HSA funding distribution.” It is a one-time trustee-to-trustee transfer that can be made from a traditional or Roth IRA. It cannot be from a SEP or SIMPLE IRA if an employer is contributing to those accounts for the plan year. An HSA funding distribution is non-deductible and tax-free (unlike a Roth conversion) but there are many rules and requirements that your client must understand and follow.

Initial eligibility. Your client must be eligible to make HSA contributions in order to make a qualified HSA funding distribution. That is, she must be enrolled in a qualifying high-deductible health plan (HDHP) and not be enrolled in Medicare.

Maximum distribution. The maximum HSA funding distribution depends on:

- The type of HDHP coverage your client has in the month she makes the contribution
- Her age at the end of the year
- Whether other contributions have already been made or will be made for the year.

For example, if she has self-only HDHP coverage in 2019, she can make an HSA funding distribution of $3,500, or $4,500 if she will be at least age 55 on December 31, 2019. If she is planning to or has already made contributions to her HSA this year, the HSA funding distribution reduces the amount she can directly contribute (and vice versa).

One lifetime distribution. In general, a qualified HSA funding distribution can be made only once in a taxpayer’s lifetime. If your client does not initially transfer the maximum possible HSA funding distribution, she cannot roll over the balance in a later month or year.

- *Exception*. If your client is enrolled in self-only HDHP coverage and later switches to family HDHP coverage in the same year, she can make an additional HSA funding distribution up to the family maximum for the year. The family maximum is $7,000 for 2019.

Testing period. Your client must remain HSA eligible during the testing period. For this purpose, the testing period runs from the month the contribution is made to the last day of the 12th month following that month. However, the “last month rule” that applies to other contributions does not apply to the HSA funding distribution testing period. A second 12-month testing period would apply to the incremental amount transferred if she makes a second distribution because she switches to family coverage.

Continuing with the example, if your client makes the HSA funding distribution during July of this year, she must remain eligible through June 30, 2020. If your client were to lose HDHP coverage and HSA eligibility before the testing period is up, the distribution would be included in income and subject to the 10% additional tax in the year the distribution is made.

A qualified HSA funding distribution provides an opportunity for taxpayers to add funds to an HSA without making an out-of-pocket contribution. Qualified HSA funding distributions are reported on line 10 of Form 8889, *Health Savings Accounts*. See “Qualified HSA funding distributions” in IRS Pub. 969, *Health Savings Accounts and Other Tax-Favored Health Plans*. Back to top