TAX in the News

Tax Information for Tax Practitioners

July 31, 2019

TAX NEWS

IRS Memo Clarifies Post-TCJA Casualty Loss Limitation—A recent Program Manager Technical Advice applies the TCJA's personal casualty loss limitation to two hypothetical scenarios. In both scenarios, it is necessary to determine if the taxpayer's loss is deductible under the new rules. The first scenario is about *when* the loss is considered sustained. The second scenario is about *where* the loss was sustained and whether it is attributable to a federally declared disaster. Page 2

Final Regulations Allow Truncated Social Security Numbers on Employee Copies of Form W-2—Recently issued final regulations will permit employers to partially mask (truncate) employees' social security numbers (SSNs) on the Forms W-2 furnished to employees. The intent of this regulation is a security measure to help protect employees' personal identifiable information (PII). Use of truncated taxpayer ID numbers on the part of employers is voluntary. The regulation is generally effective for Forms W-2 furnished to employees for tax year 2020. Page 3

QUESTION OF THE WEEK

Clients with a Coverdell ESA for their son withdrew more money than his tuition expenses for 2018. Is the excess distribution taxable and, if so, who pays the tax on it? Page 3

ORIGINAL INSIGHTS

Back to basics: Family and dependent tax rules, Part One—How the Tax Cuts and Jobs Act made the rules for family and child tax benefits and credits (even more) challenging. Full insight. View all insights at www.thetaxinstitute.com/insights/.

IRS MEMO CLARIFIES POST-TCJA CASUALTY LOSS LIMITATION

The IRS has issued a Program Manager Technical Advice (PMTA-2019-08) that sheds some light on the IRS's interpretation of how the new casualty loss limitation works with personal casualty loss situations. The PMTA applies the law to two hypothetical scenarios.

For tax years 2018-2025, the Tax Cuts and Jobs Act (TCJA) limits personal casualty loss deductions to losses attributable to a federally declared disaster. Before the TCJA, the losses discussed in the scenarios could have been deductible whether or not they were sustained because of a federal disaster.

Scenario 1: A casualty loss occurs in 2017, but is *sustained* in 2018

On May 1, 2017, a flood damages Arthur's house resulting in a personal casualty loss. The flood did not constitute a federally declared disaster. Arthur files an insurance claim and expects to recover the entire amount claimed.

In February 2018, the insurance company pays only 70% of the claim and there is no prospect of recovering the remaining 30%. The issue for this taxpayer is whether the loss was considered sustained in 2017 or 2018. If it is sustained in 2017, before the law changed, it could be deductible.

The tax regulations cover situations in which a taxpayer files a claim because of damage from a casualty or other event. Reg. §1.165-1(d)(2)(i) states that when there is a reasonable prospect of recovery, the loss is not sustained until it can be ascertained with reasonable certainty whether the reimbursement will be received or not.

Here, despite expectations, Arthur didn't know with reasonable certainty until February 2018 whether and how much of the claim would be reimbursed. Accordingly, Arthur's personal casualty loss was sustained in 2018, not 2017. Since the 2018 loss was not attributable to a federally declared disaster, it is not deductible. Before the TCJA, the determination of when the loss was sustained was still important in order to determine which year to claim the loss, but Arthur would have been able to deduct a personal casualty loss even if it not was connected to a federally declared disaster.

Scenario 2: A loss attributable to a federal disaster occurs *outside* a disaster area

On September 1, 2018, a severe storm damages Bedivere's house in Kansas resulting in a personal casualty loss. On September 7, 2018, the President issues a major disaster declaration for Kansas. The declaration authorizes FEMA, under the Stafford Act, to provide individual and/or public assistance to five counties in Kansas. Bedivere's personal casualty loss is attributable to the federally declared disaster, but Bedivere's house is *not* located in one of the five counties in the covered disaster area.

The issue for this taxpayer is whether a personal casualty loss is deductible when it is attributable to a federally declared disaster, but the damaged property is not located in the covered disaster area. Under the TCJA, the deduction is allowed only to the extent it is attributable to the federally declared disaster. A federally declared disaster is defined as a disaster determined by the President to warrant assistance by the federal government to the state under the Stafford Act.

Major disaster declarations and emergency declarations both qualify as federally declared disasters for §165(h)(5) personal casualty loss deduction purposes. Federally declared disasters are issued on a state-wide basis.

Although Bedivere's house is not located in the covered disaster area, the loss occurred in a state that received a federal disaster declaration and the loss is attributable to the disaster. Thus, Bedivere's loss is potentially deductible, assuming all other requirements are met.

> **Caution!** There were approximately 50 major disaster or emergency declarations so far in 2019. A loss is not automatically deductible just because it occurs in a state that happens to receive disaster assistance.

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> The PMTA does not give details but makes it clear that Bedivere's loss occurred just before the declaration was made and was attributable to the disaster. Perhaps Bedivere's house is in a nearby county and presumably the taxpayer can demonstrate that the damage was caused by the same severe storm that warranted the federal declaration.

As with Scenario 1, before the TCJA, the taxpayer's loss could have been deductible even if not attributable to a federally declared disaster.

Also, the IRS's authority to postpone tax return due dates and other federal obligations is covered by a different part of the law and tax regulations (§7508A and Reg. §301.7508A). Usually, postponements apply when the disaster warrants individual assistance. Individuals who don't live or work in a covered disaster area are eligible for postponements only if their books and records are located in the area or they're visiting the area when the disaster occurs.

See FEMA's Disaster Declaration Process for more information on the Stafford Act.

FINAL REGULATIONS ALLOW TRUNCATED SOCIAL SECURITY NUMBERS ON EMPLOYEE COPIES OF FORM W-2

The Treasury Department and IRS have issued final regulations (TD 9861) permitting employers to use truncated taxpayer ID numbers (TTINs) on Forms W-2 furnished to employees. The purpose of TTINs is to help protect employees' identity by not displaying the employee's full taxpayer ID number.

Under the final regulations, employers are permitted to mask numbers so that only the last four digits display. A TTIN can use X's or asterisks for the first five digits, such as XXX-XX-1234, or ***-**-1234.

The final regulations generally adopt proposed regulations issued in 2017 with some clarifications.

- The use of TTINs is *voluntary*.
- TTINs may be used *only* on copies of Forms W-2 furnished to employees (copies B, C, and 2).
- An employer may not truncate the employer's own employer ID number (EIN) on the employee's copy of the W-2.
- Employers may not truncate SSNs on Copy A of Form W-2 filed with the Social Security Administration. Both the SSA and IRS (who receives the employer's W-2 file from the SSA) require the full number.

The regulations apply to returns, statements, and other documents required to be filed or furnished after December 31, 2020 (generally, Forms W-2 filed in 2021 for tax year 2020). The restriction against filing W-2s with truncated numbers with the SSA or IRS is effective after July 3, 2019, that is, immediately. The IRS intends to revise forms and instructions to reflect these rules.

QUESTION OF THE WEEK

Q. Our clients have a Coverdell ESA for their son and started taking distributions from it in 2018 to help pay for his college tuition. They planned to spend $8,500 and withdrew that amount, but they only ended up with $7,500 in qualified education expenses. The excess distribution is about $1,000. The 1099-Q they received shows a fair market value of $16,000 but has no entries in boxes 2 or 3.

Is the excess taxable? If so, would the clients or their son have to pay tax on it? Their son has a job and files his own return, but he's still their dependent.

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A. Because the ESA distribution was more than their son's qualified education expenses, there is tax on the excess distribution, but only a portion of it will be taxable.

The ESA distribution includes basis (contributions) and accumulated earnings. The taxable portion of the excess distribution is a portion of the accumulated earnings. If the Form 1099-Q doesn't have earnings and basis, you'll need to follow four steps to determine the taxable portion of the distribution.

Step 1. The basis portion of the distribution.

Step 2. The earnings portion of the distribution.

Step 3. The tax-free portion of the earnings.

Step 4. The taxable portion of the earnings.

Before going through the calculation, let's assume:

- *Basis*. Your clients contributed $20,000 in total to the ESA and did not make any more contributions after 2017. The $20,000 therefore represents the basis in the ESA.
- *Adjusted qualified education expenses (AQEE)*. Your clients' son did not receive any scholarships, grants, etc. so AQEE for 2018 was $7,500.
- *Fair Market Value (FMV).* Your clients determined that the FMV of the ESA at the end of 2018 (after the withdrawal) was $16,000.

Follow these steps to figure the taxable portion of the distribution:

Step 1. Multiply the total distribution by a fraction. The numerator is the account basis and the denominator is the FMV (account balance) at the end of 2018 plus the distributed amount.

$6,939 basis portion of distribution [$8,500 distribution × $20,000 basis ÷ ($16,000 FMV + $8,500 distribution)]

Step 2. Subtract the basis portion from the total distribution to obtain the earnings portion.

$1,561 earnings portion of distribution ($8,500 distribution - $6,939 basis portion)

Step 3. Multiply the earnings portion by a fraction. The numerator is the AQEE and the denominator is the total distribution.

$1,377 tax-free earnings ($1,561 earnings portion × $7,500 AQEE ÷ $8,500 distribution)

Step 4. Subtract tax-free earnings from total earnings

$184 taxable earnings ($1,561 earnings portion - $1,377 tax-free earnings)

The taxable earnings must be reported on your clients' son's tax return because he is the ESA beneficiary. For 2018, the amount should be reported on line 21 of Schedule 1 (Form 1040). The excess distribution is also subject to the 10% additional tax, about $18 in this case. See "Distributions" starting on page 45 of IRS Pub. 970, *Tax Benefits for Education*. This chapter also has a worksheet that is useful if there are additional complications in the calculation, including scholarships, education credits claimed, and rollovers.