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AUGUST 2018 VOLUME 5.8

Cost segregation studies and §1031 under the TCJA .... *Page 1*

Draft 1040 released by IRS .... *Page 2*

Updated W-4 draft released ... *Page 3*

Solar credit guidance for businesses .... *Page 4*

Who has the authority to admit someone to a health care facility?.................................. *Page 6*

IRS creates webpage on understanding "Letter 227" .... *Page 7*

Employers can be held liable for third-party payroll service provider's errors................... *Page 8*

Inherited basis in joint tenancy assets .... *Page 9*

IRS not bound by informal communication.................... *Page 11*

IRS lassos in ranchers' losses... *Page 12*

Sole proprietor prevails on travel expense audit by utilizing *per diem* rates .... *Page 13*

***Wayfair*: physical presence no longer required** .... *Page 15*

Tax treatment of home rentals depends on how you use it ... *Page 15*

News Briefs.......................... *Page 18*

Upcoming due dates .... *Page 20*

Cost segregation studies and §1031 under the TCJA

TAX: There are differing opinions regarding how the new law will affect exchanges of property subject to cost segregation.

By Mike Giangrande, JD LL.M.
Federal Tax Editor

Under the TCJA, nonrecognition of gain or loss on like-kind exchanges under IRC §1031 is limited to real property not held primarily for sale.[1]

Therefore, under the new law, when a taxpayer enters into a like-kind exchange and relinquishes a property whose components were segregated under a cost segregation study, how will the §1245 property be treated?

Cost segregation studies

Property, whether acquired or constructed, often consists of numerous asset types with different recovery periods. To properly compute depreciation, property is typically separated into individual components or asset groups having the same recovery periods and placed-in-service dates.

When the actual cost of each individual component is available, this is a simple procedure. However, when only lump-sum costs are available, cost-estimating techniques may be required to "segregate" costs into individual components of property, such as land, buildings, improvements, equipment, furniture and fixtures, etc. This is the point of a cost segregation study.

Cost segregation studies are most commonly prepared for the allocation or reallocation of building costs to tangible personal property. A building termed "IRC §1250 property" is generally nonresidential real property (depreciable over 39 years) or residential rental property (depreciable over 27½ years) eligible for straight-line depreciation.

Equipment and furniture and fixtures termed "IRC §1245 property" is tangible personal property. Tangible personal property has a shorter recovery period (typically five to 15 years) and is also eligible for accelerated depreciation under MACRS, as well as bonus depreciation and IRC §179 expensing. Therefore, a faster depreciation write-off (and tax benefit) can be obtained by allocating property costs to IRC §1245 property.

Guidance needed

One side of this issue argues that it would appear that only the real property — nondepreciable land and IRC §1250 property (the buildings) — is eligible for nonrecognition treatment.[2]

However, on the other side there is an argument that §1245 treatment for depreciation purposes is just that — for depreciation purposes. Taking advantage of the benefit provided by §1245 doesn't make property inherently personal property. Also, many other code sections define real property, for example §263A, so which section is controlling? Bolstering this argument is a footnote in the Joint Conference Committee report expressing Congress' intent to not change §1031 exchange treatment for real property exchanges.

We'll keep you informed on any progress regarding whether the IRS has the regulatory authority, and desire, to provide that segregated components of a building still qualify as real property.

1 TCJA §13303; IRC §1031

2 IRC §1031(a)(1)

Draft 1040 released by IRS

The Department of the Treasury has released a draft of the new 2018 Form 1040 "Postcard" in light of the Tax Cuts and Jobs Act. They managed to get it down to a two-sided postcard, but to do so, they had to add six more schedules to the return:

- Schedule 1, Additional Income and Adjustments to Income;
- Schedule 2, Tax;
- Schedule 3, Nonrefundable Credits;
- Schedule 4, Other Taxes;
- Schedule 5, Other Payments and Refundable Credits; and
- Schedule 6, Foreign Address and Third Party Designee.

You can view the draft version of the new 1040 and the schedules at:

www.caltax.com/spidellweb/public/editorial/1040postcard.pdf

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SPIDELL'S FEDERAL TAXLETTER is published monthly on the fifteenth day of each month by Spidell Publishing, Inc., 1134 North Gilbert Street, Anaheim, California 92801-1401. Periodicals postage paid at Anaheim, CA, and additional entry office. Telephone: (714) 776-7850. Fax: (714) 776-9906. E-mail: subscriptions@spidell.com. Website: www.caltax.com. The subscription price is $129 for 12 months. ©2018, Spidell Publishing, Inc. POSTMASTER: Please send address changes to Spidell's Federal Taxletter, P. O. Box 61044, Anaheim, California 92803-6144. Federal law prohibits unauthorized reproduction of the Spidell's Federal Taxletter. All reproduction must be approved in writing by Spidell Publishing, Inc. Publisher Emeritus: Robert Spidell. Publisher: Lynn Freer. Editor: Kathryn Zdan. Associate Editor: Renée Rodda. Contributing Editor: Sandy Weiner, J.D. Federal Tax Editor: Michael Giangrande, J.D., LL.M. Contributing Editor: Diane Fuller. Managing Editor: Austin Lewis. Layout: Ana Cervantes.

Updated W-4 draft released

TAX: And you thought the 1040 "Postcard" was a joke.

By Lynn Freer, EA
Publisher

The IRS has released a draft of the 2019 W-4, Employee's Withholding Allowance Certificate. The W-4 has been completely redesigned and is basically unusable. Most taxpayers with anything more than a 1040EZ will need to use an online calculator to complete the form.

Here are some problems we see at first glance:

- Using the form itself means the employer will know of any other income and deductions the employee has. This could cause serious privacy concerns;
- If an employee does not want to share this confidential information with the employer, they can use an online calculator to complete the form; and
- Both the form and the calculator require the employee to have information from their tax return, which will require the taxpayer to pull out last year's tax return and make adjustments for this year assuming that the taxpayer knows the law.

The computation on the current calculator seems accurate. Both the calculator and the new W-4 form have places for "nonwage" income.

The draft W-4 does not provide for a withholding allowance number to be entered (the current W-4 provides a spot to put this information). However, it does have a line that allows for an additional amount to be withheld. The 2019 draft form says if you don't want to provide the employer with the information requested on lines 5–8 for privacy reasons, you can skip those lines and enter one number on line 9. You can use the calculator to compute withholding and enter that amount on line 9. You can also have the employer compute withholding based on the information you provided on lines 5–8, and enter any additional withholding on line 9 for whatever reason.

The instructions have an example of what to do if you have multiple employers, but they are very unclear and not intuitive.

Using the online calculator is currently five pages of questions and basically prepares the return and will likely provide the withholding amount for each employer. Imagine: You have a new employee filling out paperwork including the W-4. Set aside four hours of time for them to either go through the calculator or make up numbers. Surprise: The client owes $10,000 because they didn't call you to compute the withholding.

The new form also reportedly has 11 pages of instructions that point the employee to 12 different forms and publications to correctly complete the W-4. These instructions are not yet available.

You can see the draft form at:

www.irs.gov/pub/irs-dft/fw4--dft.pdf

In response to reactions to the new W-4, the IRS is pushing its online W-4 calculator. But tax pros have reported that the calculator is difficult to use and results in underwithholding.

You can access the calculator at:

www.irs.gov/individuals/irs-withholding-calculator

The IRS has stated that they will be coming out with revisions to the draft form. We suggest they go back to the drawing board and come up with something that doesn't force a taxpayer to complete a tax return every time a situation changes.

Solar credit guidance for businesses

TAX: Detailed rules determine when construction begins.

By Mike Giangrande, J.D., LL.M.
Federal Tax Editor

Notice 2018-59 provides guidance for taxpayers to determine when construction begins for purposes of calculating the business solar credit.

Practice Pointer

The business solar credit is claimed in the year construction is complete, but the amount of the credit is determined based on the year construction begins.

The amount of the energy credit for equipment that generates solar energy under IRC §48(a)(3)(A)(i) and (ii) is 30% of the basis of such property. The credit is reduced in the case of property for which construction begins after 2019. The following chart details the phasedown of the credit:[1]

Credit Phasedown

Construction beginning dates	Credit amount
Prior to January 1, 2020	30%
In 2020	26%
In 2021	22%
After 2021	0%

If the solar energy property construction begins during the dates listed above and the property is not placed in service before January 1, 2024, then the credit is reduced to 10% of the basis of the property.[2]

Note: IRC §48 provides for credits for expenditures on nonresidential energy property. The energy credit provided under IRC §48 is part of the investment credit provided under IRC §46, which, in turn, is part of the general business credit provided under IRC §38.

When does construction begin?

The notice provides two tests to establish the beginning of construction:

- The physical work test; and
- The 5% safe harbor test.

A taxpayer is deemed to have begun work on the earliest date the taxpayer satisfies either test.

The physical work test

A taxpayer satisfies the physical work test when physical work of a significant nature begins. This test focuses on the nature of the actual work performed, not the amount or the cost, and both off-site and on-site work may be taken into account. However, it does not include preliminary activities, even if the cost of the preliminary activities will be included in the depreciable basis of the property. Notice 2018-59 does not otherwise define "work of a significant nature."

The 5% safe harbor test

A taxpayer satisfies the 5% safe harbor test if a taxpayer pays or incurs 5% or more of the total cost of the energy property.

All costs that will be part of the depreciable basis of the business solar property are taken into account to determine whether the 5% test is met.

Continuity requirement

Once a taxpayer meets either the physical work test or the 5% safe harbor test, the taxpayer must make continuous progress toward completion of the project. Whether a taxpayer meets the continuity requirement is based on all the facts and circumstances including, but not limited to:

- Paying or incurring additional amounts included in the total cost of the energy property;
- Entering into binding contracts for the manufacture, construction, or production of components of property or for future work to construct the energy property;
- Obtaining necessary permits; and
- Performing physical work of a significant nature.

Disruptions to the continuity requirement that are beyond the taxpayer's control are not an indication that the taxpayer has failed to satisfy this requirement.

Continuity requirement safe harbor

The continuity requirement is deemed satisfied if the taxpayer places the business solar property in service by the end of the fourth calendar year after the calendar year the construction of the energy property began.

Example of continuity safe harbor: ABC, Inc. satisfies the physical work test and the 5% safe harbor test (and has therefore begun construction) on August 18, 2018. The continuity safe harbor deadline for ABC, Inc.'s solar project is December 31, 2022.

As long as the solar project is completed by December 31, 2022, then ABC, Inc. has satisfied the continuity requirement.

Notice 2018-59 does not address what happens if the continuity requirement is disrupted. Presumably, if the continuity requirement is disrupted, the taxpayer would then be required to determine a new construction begin date. In that scenario, a new construction beginning date in a later year could give rise to a reduced credit.

Transfer of energy property

Business solar property acquired by a taxpayer after the construction beginning date but before the property is first placed in service will determine its construction beginning date by reference to the transferor of the property.[3]

Example of transfer of energy property: On June 29, 2019, XYZ, Inc. purchased a new construction office building, but before it was placed in service by the builder. On February 2, 2018, the builder satisfied the 5% safe harbor test for solar panels that will be installed on the building. On November 30, 2020, the building and its solar property is completed.

XYZ, Inc. is able to use the builder's construction begin date of February 2, 2018, when it calculates its solar credit. This allows XYZ, Inc. to claim the 30% credit (available in 2018 when construction begins) instead of the reduced 26% credit (available in 2020).

However, if the taxpayer only acquires tangible personal property, including contractual rights, from an unrelated party, then any work performed or amount paid or incurred by the transferor is not taken into account for purposes of the physical work test or the 5% safe harbor test.

1 IRC §48(a)(6)(A)

2 IRC §48(a)(6)(B)

3 IRC §48(a)(3)(B)

Who has the authority to admit someone to a health care facility?

LEGAL ISSUES: Understand what decision-making authority is granted under a POA.

By Renée Rodda, J.D.
Contributing Editor

A woman who admitted her sister to a residential care facility for the elderly made a "health care" decision in doing so, which she was not authorized to make.[1] The woman was designated as an attorney-in-fact under a power of attorney (POA) to make a number of legal and financial decisions only for her sister, but she was not designated to make health care decisions.

This became an important distinction when the woman and another family member sued Eskaton Fountainwood Lodge (Fountainwood) for elder abuse after the death of the sister (Barbara Lovenstein). Fountainwood attempted to enforce an arbitration clause that was part of the admission agreement when Barbara was admitted. However, the court found that the clause was not enforceable because:

- The individual who admitted Barbara was not Barbara's attorney-in-fact for health care decisions; and
- Admission to Fountainwood was a health care decision.

Incapacity planning, and the use of POAs, is a major component of an estate plan. It is not uncommon for people to designate one person to serve as a health care agent under what is commonly referred to as a health care directive and another person to make financial decisions under a general POA. The question is, what role does one agent have as opposed to the other in the context of contracting for medical services?

This case gave us some guidance in that area and serves as an excellent reminder that an attorney-in-fact under a POA must understand the decisions they are authorized to make and those that they are not. Although, in this case, it worked out to the benefit of the attorney-in-fact because she was allowed to pursue the litigation, making an unauthorized decision could cause serious problems for a well-meaning attorney-in-fact.

The POAs

In 2006, Lovenstein executed a POA designating her niece as her attorney-in-fact for health care decisions. This POA included the power to authorize Lovenstein's admission to "any hospital, hospice, nursing home, adult home, or other medical care facility," and the authority to consent to the provision, withholding, or withdrawal of health care.

In 2010, Lovenstein also executed a personal care POA. She designated her sister and her niece as her attorneys-in-fact to act for her on a number of different subjects, including "personal and family maintenance," and "claims and litigation." The form expressly precluded anyone from making "medical and other health-care decisions" for her under authority of the personal care POA.

Admission to the facility

In 2012, Lovenstein's sister voluntarily admitted her to Fountainwood, a licensed "residential care facility for the elderly" under the California Residential Care Facilities for the Elderly Act.[2] At that time, the sister signed the admission agreement on behalf of Lovenstein, which contained an arbitration clause. The clause in general required all claims arising from Lovenstein's care at Fountainwood to be submitted to binding arbitration.

A medical appraisal performed the day of her admission disclosed Lovenstein was suffering from dementia and seizures. She was confused, disoriented, engaged in inappropriate, aggressive, and wandering behaviors, was not able to follow instructions consistently, and she was depressed. Lovenstein required "complete" supervision.

As a result, it was clear that the sister made the decision to admit Lovenstein because Lovenstein was not capable of making that decision for herself.

Arbitration clause void

The court of appeal found that the decision to admit Lovenstein was a health care decision, and the sister/attorney-in-fact who admitted her, acting under the POA, was not authorized to make those kinds of decisions. As a result of this conclusion, the court affirmed the trial court's denial of a motion by the residential care facility to compel arbitration. Because the sister did not have authority to admit Lovenstein to the residential care facility for the elderly, her execution of the admission agreement and its arbitration clause were void. Therefore, she was able to pursue the elder abuse action against the facility.

[1] ***Hutcheson v. Eskaton Fountainwood Lodge*** (June 14, 2017) Cal. Court of Appeal, Third District, Case No. C074846

[2] Health & Saf. Code §1569 et seq.

IRS creates webpage on understanding "Letter 227"

INSURANCE: The letter provides guidance to employers subject to penalties for failing to provide health insurance.

By Lynn Freer, EA
Publisher

When the IRS suspects that an applicable large employer (ALE) may be liable for an employer shared responsibility payment (ESRP),[1] they send the employer Letter 226-J. If the ALE disagrees with the proposed ESRP liability, they file Form 14765, Employee Premium Tax Credit (PTC) Listing. If they agree, they complete Form 14764, ESRP Response.

When an ALE files Form 14764, the IRS responds with one of five 227 letters:

- Letter 227-J: States the proposed penalty amount that will be assessed because the ALE agreed with the proposed penalty. No response is required to this version of the letter, and the case is considered closed.
- Letter 227-K: Shows the penalty amount is zero. No response is required to this version of the letter, and the case is considered closed.
- Letter 227-L: Shows the proposed penalty amount has been revised. This letter includes an updated Form 14765, Employee Premium Tax Credit (PTC) Listing, and revised calculation table. The ALE can agree with the revised penalty amount, request a meeting with IRS, or appeal.
- Letter 227-M: The penalty amount did not change. This letter also includes an updated Form 14765 and revised calculation table. The ALE can agree with the revised penalty amount, request a meeting with IRS, or appeal the determination.
- Letter 227-N: Acknowledges the decision reached by the IRS appeals office, shows the resulting penalty amount, and the case is considered closed. No response is required to this version of the letter.

Of the letters, only Letter 227-L and Letter 227-M require a response that must be provided by the date stated in the respective letter.

The webpage covers the versions of the letter, provides instructions on what to do, and answers common questions. The page is available at:

www.irs.gov/individuals/understanding-your-letter-227

[1] IRC §4980H

Employers can be held liable for third-party payroll service provider's errors

TAX: There are varying degrees of liability protection for employers.

By Kathryn Zdan, EA
Editor

If an employer uses a third-party payroll service provider, the employer is the one liable for any taxes and unpaid penalties in the event the payroll service provider fails to make the payments.

Employers can use the Department of the Treasury's free Electronic Federal Tax Payment System (EFTPS) to monitor the payroll service provider and ensure that tax deposits are being made.

Alternatively, employers may enter into a service contract with a certified professional employer organization (CPEO) in which the CPEO agrees to take over some or all of the employer's federal employment tax responsibilities and obligations. Generally, the CPEO is solely liable for paying the employer's employment taxes, filing returns, and making deposits and payments for the taxes reported for most employees. The employer may still be liable for certain nonworksite employees' withholding.

A list of the currently approved CPEOs is available at:

www.irs.gov/tax-professionals/cpeo-public-listings

More information on outsourcing payroll to third parties is available at:

www.irs.gov/businesses/small-businesses-self-employed/outsourcing-payroll-and-third-party-payers

Note: If an employer uses a PEO rather than a CPEO (the difference is the lack of certification with the IRS), the employer is still on the hook if the PEO doesn't turn over payroll taxes to the federal government. In contrast, a CPEO is liable for not making payroll deposits.[1]

Reasonable cause

A taxpayer who fails to timely file, pay, and deposit employment taxes is assessed a penalty, unless such failure is due to reasonable cause and not due to willful neglect.[2] The Supreme Court has held that the taxpayer "bears the heavy burden" of proving both:[3]

- That the failure did not result from "willful neglect"; and
- That the failure was "due to reasonable cause."

Willful neglect may be interpreted as "a conscious, intentional failure or reckless indifference."[4] Reasonable cause requires the taxpayer "to demonstrate that he or she exercised ordinary business care and prudence but nevertheless was unable to file the return within the prescribed time."[5]

For a discussion of case law on this topic, see "Relying on third party to remit payroll taxes" in the November 2016 issue of *Spidell's Federal Taxletter*®.

1 CCA 201724025; IRC §§3511, 7705

2 IRC §§6651(a), 6656(a)

3 ***United States v. Boyle*** (1985) 469 U.S. 241

4 *Id.*

5 *Id.*

Inherited basis in joint tenancy assets

ESTATE TAX: The rules are different, depending on who the joint tenant is.

By Renée Rodda, J.D.
Contributing Editor

We frequently have questions concerning how to determine the basis of inherited property when the property is held in joint tenancy. There is one set of tax rules for spousal joint tenancies and a different set for joint tenancies that include nonspouses. The conflict between these two sets of rules often causes confusion when it comes to a surviving joint tenant's basis in inherited property.

Married joint tenants

For estate tax purposes, one-half of the fair market value of joint tenancy property held by two spouses is included in the gross estate of the first spouse to die. This is true regardless of how much each spouse contributed toward the purchase price of the property.[1]

Calculate the basis for a surviving spouse by adding one-half of the property's cost basis to the value included in the gross estate. Subtract from this sum any deductions for wear and tear (such as depreciation or depletion) allowed on that property to the surviving spouse.[2]

Comment

There has been much discussion (and several court cases) addressing whether California community property laws supersede the fact that a couple elects to hold title as joint tenants. While some taxpayers have been successful with this argument, the IRS has not acquiesced to it, and it will likely require a court decision.

In some cases, a statement in the couple's will or a written agreement that all property shall be treated as community property has been sufficient. However, with newer methods of holding title (like community property with right of survivorship), joint tenancy probably should not be used between spouses in California.

Example of married joint tenants: Jack and Jill were a married couple. They owned as joint tenants rental property they purchased for $100,000. Jill paid $25,000 of the purchase price and Jack paid $75,000.

When Jack died, the FMV of the property was $400,000. Depreciation deductions allowed before his death were $50,000. Jill's basis in the property is $225,000, calculated as follows:

One-half of original cost basis (50% of $100,000)	$ 50,000
Interest acquired from Jack (50% of $400,000)	200,000
Minus one-half of $50,000 depreciation	(25,000)
Jill's basis	$225,000

Unmarried joint tenants

The entire value of a joint tenancy asset held by unmarried joint tenants is presumed to be included in the estate of the first joint tenant to die. The asset may be excluded from the estate, however, if the surviving joint tenant can prove his or her contribution to the acquisition of the asset.[3] The surviving joint tenant then gets a step-up in basis equal to the amount that was included in the decedent's estate.[4]

Calculate the surviving tenant's new basis in the property by adding his or her original basis to the value of the property that was included in the decedent's estate. Subtract from this sum any deductions for wear and tear, such as depreciation or depletion, allowed on that property to the surviving joint tenant.

Example of unmarried joint tenants: If Jack and Jill from the previous example were not married, and Jill had contributed 25% to the property, Jill's new basis in the property would be $300,000, calculated as follows:

Jill's original basis (25% of $100,000)	$ 25,000
Interest acquired from Jack (75% of $400,000)	300,000
Minus one-half of $50,000 depreciation	(25,000)
Jill's basis	$300,000

It is important to keep in mind that the estate tax rules are different from the income tax rules. For income tax purposes, the property is held 50% by each joint tenant, so they are each required to report 50% of the income from the property on their individual tax returns regardless of the amount of their actual contributions.

Also, if the property is sold, each joint tenant will report 50% of the gain from the sale. Although the cost of the property for estate tax purposes is considered to be based on the contribution by each joint tenant, the accumulated depreciation for the surviving tenant is 50% of the total.

Gifted joint tenancy

Gifts from the decedent are not allowed as contributions from nonspouse survivors, no matter how attenuated. So, if an individual simply adds a friend or a family member on to a piece of property as a joint tenant, 100% of the fair market value of that asset will be included in the decedent's estate when he or she dies and the property passes to the surviving joint tenant.

This is true even if a gift tax return is filed. The gift is simply ignored for estate tax purposes, and any gift tax paid is treated as a prepayment of estate tax.[5]

Because the full value of the property is included in the decedent's estate, the survivor will get a 100% step-up in basis.

Example of gifted joint tenancy: Frank owns a home with a basis of $100,000 and a fair market value of $400,000. Frank transfers the title to the home from his sole and separate property to a joint tenancy with his daughter, Jeanine.

Frank files a gift tax return to report the $200,000 gift to Jeanine, and at the time of the gift, her basis in the property is $50,000 (one-half of Frank's basis); Frank dies later that year.

All of the $400,000 fair market value of the home is included in Frank's estate, and Jeanine's basis in the property is stepped up to $400,000.

Again, for income tax purposes, the property is held 50% by each joint tenant, so they are each required to report 50% of the income from the property on their individual tax returns. If the property is sold, each joint tenant will report 50% of the gain from the sale.

If the property is subject to a mortgage and one of the joint tenants makes all of the monthly payments, the monthly mortgage payments are also gifts to the other joint tenants.[6]

Example of mortgage payments: Hank buys a piece of property, paying $30,000 as a down payment and assuming a mortgage of $120,000. He had the title conveyed to himself and his son Chris as joint tenants with right of survivorship.

Hank made a gift of $15,000 to Chris on the purchase of the property. Each month in which Hank pays $3,000 of the mortgage debt, Hank makes a gift of $1,500 to Chris.

If a joint tenant pays for improvements to the property or makes principal mortgage payments, he or she will have made a contribution toward the purchase of the property, and that portion of the property will not be considered a gift.[7]

Example rental income used to make payments: Assume that the property Hank purchased in the previous example was a rental.

Any income generated by the rental will be shared equally by Hank and Chris. If the rental income is used to make the mortgage payments, Chris will be making a contribution toward the purchase of the property.

So, if the $120,000 mortgage is paid off by the rental income, Chris will have contributed $60,000 of the principal (or 40% of $150,000 cost).

1 IRC §2040(b)(1)

2 IRC §1014(b)(9)

3 IRC §2040(a); Treas. Regs. §20.2040-1(a)

4 IRC §1014(b)(9)

5 IRC §2013

6 Rev. Rul. 78-362

7 IRC §2040(a); Treas. Regs. §20.2040-1

IRS not bound by informal communication

TAX: It doesn't count if it's not on the proper form.

By Kathryn Zdan, EA
Editor

Taxpayers who received correspondence from various IRS agents stating that penalties had been abated were still held liable for those penalties.[1] The taxpayers received multiple conflicting communications from the IRS, and they relied on statements that listed transaction penalties assessed under IRC §6707A would not be assessed, which they later were.

While the correspondence made clear statements, such as "In reviewing your account, our records show that all penalties have been waived for the tax years listed above," the court found that the correspondence did not rise to the level of a closing agreement. Therefore, the IRS was not bound to waiving the penalties.

Any closing agreement, in order to be valid, must be made on the appropriate IRS form, which in this case would have been Form 866, Agreement as to Final Determination

of Tax Liability, or Form 906, Closing Agreement On Final Determination Covering Specific Matters.[2]

The court noted that the correspondence the taxpayers received did not include the formal language necessary to indicate the IRS's intent to settle an account.

Practice Pointer

This case illustrates the need to get a closing agreement from the IRS rather than relying on informal communications from a revenue agent.

[1] *Hinkle v. U.S.* (June 15, 2018) U.S. District Court, District of New Mexico, Case Nos. 1:16-cv-01048 KG/SCY, 1:16-cv-01051 KG/SCY, 1:16-cv-01052 KG/SCY

[2] Treas. Regs. §301.7121-1(d)(1)

IRS lassos in ranchers' losses

TAX: High-income taxpayers were engaged in ranching business but subject to passive activity loss limitations.

By Sandy Weiner, J.D.
Contributing Editor

A Silicon Valley tech company executive and his wife decided to make a run at ranching and purchased a 400+ acre ranch in southern Utah. Although the husband's family had operated ranches while he was growing up, he had never been actively involved in the business.

The IRS argued that the taxpayers' skill sets in managing computer tech companies and a physical therapy business (the wife's business) did not translate into running a profitable ranching business.

However, the Tax Court found that even after 16 years of running the ranch at a loss, the taxpayers did their best to make the ranch profitable and therefore the hobby loss limitations did not apply, but because the taxpayers functioned as passive investors, their losses were subject to the passive loss limitation rules.[1]

Trade or business

The IRS disallowed over $2.8 million in losses that the taxpayers claimed over a five-year period. The IRS argued that the 16 years of operating at a loss demonstrated that the taxpayer/husband, who received over $21 million of tech-related income during the tax years at issue, was merely dabbling in the ranching business as a hobby.

Although the Tax Court found that operating at a loss for 16 straight years was a strong indicator that the business was not operated for profit, the manner in which the taxpayers conducted their business demonstrated that they were doing their best to bring their operations out of the red.

They hired competent staff, met with them weekly, and consulted various experts in the field. They maintained separate books and accounts and maintained records in such a way as to identify how to cut expenses and build on profitable activities.

They discontinued the ranch's horse breeding activities when they determined that there was no way to make a profit and put all their efforts into cattle ranching. Although they still operated at a loss, the records indicated that they undertook various strategies to cut their expenses and increase their income.

The court did note that the case was very close given the length of time of operating at a loss and the fact that the taxpayers had no real plan to make the ranch a profit-making operation. However, the court found that the taxpayers' activities could not be characterized as a "hobby," noting that the taxpayers' efforts to reduce the ranch's expenses and the actual decrease in the net losses during the tax years at issue were "most persuasive."

Passive investors

The taxpayers' win was short-lived when the Tax Court ruled that the taxpayers were not material participants in the ranching activity but rather passive investors subject to the IRC §469 passive loss limitations. The court focused on two of the seven tests used to determine whether the taxpayers were involved in the operations on a regular, continuous, and substantial basis so as to be considered a material participant.[2]

Under the 500-hour test, a taxpayer is considered a material participant if he/she participates in the activity for more than 500 hours during the year. A husband and wife are considered one unit, so their hours are combined. However, hours spent conducting investor-type activities are not counted. Only those types of activities involved in the day-to-day business operations qualify.

In this case, the taxpayers did not keep any contemporaneous logs, and their annual logs prepared for trial did not substantiate that they spent the requisite number of hours in noninvestor activities.

A taxpayer can also demonstrate material participation using a facts and circumstance test. However a taxpayer's management activities under this test are not taken into account if another person also receives compensation for management services relating to the activity or if another person spends more time performing management services relating to the activity than the taxpayer. Because the taxpayers hired a full-time ranch manager to oversee the ranch operations, they did not qualify as material participants under the facts and circumstances test.

As passive investors, their losses were suspended until such time as they actually turn a profit or sell the ranch … more motivation to fatten up those cows.

[1] *Robison v. Comm.*, TCM 2018-88

[2] Treas. Regs. §1.469-5T(a)

Sole proprietor prevails on travel expense audit by utilizing *per diem* rates

Tax: Unfortunately, he used the wrong rates and lost much of his deduction.

By Mike Giangrande, J.D., LL.M.
Federal Tax Editor

A taxpayer prevailed in an IRS audit challenging his travel expenses by properly establishing his tax home.[1] The taxpayer lived in King County and owned 110 acres of timberland straddling Thurston and Lewis counties, all within the state of Washington. The taxpayer was retired, and his main sources of income were Social Security, pensions, and investment income.

Although otherwise retired, the taxpayer personally maintained the 110 acres of timberland, which he reported on Schedule C of his personal income tax return. In that pursuit, he spent 167 days at the timberland property during the tax year at issue.

The IRS denied the taxpayer's deductions for travel expenses to the timberland property.

Tax home

The IRS's position was that the taxpayer was not "away from home" when he worked and stayed at the timberland property because that property was his tax home, not his residence in King County, as the taxpayer claimed.

A taxpayer's home is generally considered to be his regular or principal place of business.[2] If a taxpayer has no regular or principal place of business, then his abode, in a real and substantial sense, is where personal and business connections are made. If a taxpayer meets neither category, then he is considered to be an itinerant whose tax home is wherever he happens to work.

The taxpayer prevailed (sort of)

The taxpayer testified that it was necessary for him to spend so much time at the timberland properties because when he was not there, timber was illegally harvested by others, which presented a loss of the most valuable asset on the property. Additionally, the timber activity was too small to warrant hiring others to plant, protect, and maintain the trees.

Based on the taxpayer's testimony and the fact that he spent most of the year at his primary residence in King County, the Tax Court ruled in his favor. The court pointed out that the only evidence the IRS could present that the timberland property was his tax home was the fact that he spent a lot of time there.

The taxpayer deducted travel expenses going to and from his timberland and used *per diem* amounts allowed for travel, which the taxpayer determined using IRS Publication 463, Travel, Entertainment, Gift and Car Expenses. The taxpayer determined his *per diem* travel expense at $59,960 (averaging $359 per day), which the IRS disallowed in full. The taxpayer reported no income on Schedule C for the year at issue because timberland properties such as the taxpayer's typically have large income in the year the timber is harvested, followed by multiple years of no income.

Unfortunately, the taxpayer misapplied the *per diem* amounts by applying the highest *per diem* amount he could find in the IRS tables in Publication 463, which applied to luxury water travel. When the correct *per diem* rates were applied, the taxpayer was only entitled to a deduction of $8,934.50 ($53.50 per day).

Deducting *per diem* travel on Schedule C

Self-employed individuals can deduct meal and incidental expenses computed at the federal rate established for the locality in which meal expenses were incurred while away from home.[3] The federal published rate is deemed to be automatically substantiated for purposes of Treas. Regs. §1.274-5T(b)(2)(i) and (c) substantiation requirements. Self-employed individuals may not use this method to substantiate lodging expenses.

Per diem rates can be found here:

www.gsa.gov/travel/plan-book/per-diem-rates

[1] *Maki v. Comm.*, TCS 2018-30

[2] Rev. Rul. 93-86

[3] See Rev. Proc. 2011-47

Wayfair: physical presence no longer required

TAX: But this decision raises more questions than it answers.

By Sandy Weiner, J.D.
Contributing Editor

In a 5-4 decision, the U.S. Supreme Court ruled in ***South Dakota v. Wayfair, Inc.*** that states can now require sales and use tax to be collected by retailers who make sales over the internet to customers in another state even if the retailer doesn't have physical presence in the customer's state.[1] The ruling in ***Wayfair*** in a nutshell means that sales alone are enough to create nexus for sales and use tax purposes and that a physical presence is no longer required.

This case leads to some interesting questions, which will need to be sorted out. The biggest question is what is the minimal number of sales an out-of-state businesses must have with a state to be required to collect use tax. ***Wayfair*** addressed South Dakota's law that requires out-of-state retailers to collect use tax on sales made to South Dakota customers if the seller on an annual basis:

- Delivers more than $100,000 of goods or services to South Dakota addresses; or
- Engages in 200 or more separate transactions for the delivery of goods and services into South Dakota.

Although the Court remanded the case to the lower court to determine if the law otherwise comported with the U.S. Commerce Clause, the Court outlined various reasons why it felt the law might pass constitutional muster.

Forty-one states and the District of Columbia filed briefs in support of South Dakota, so it is highly likely that these states will be enacting similar legislation in the very near future.

[1] ***South Dakota v. Wayfair, Inc.*** (June 21, 2018) U.S. Supreme Court, Case No. 17-494

Tax treatment of home rentals depends on how you use it

TAX: Whether a property is used for personal, rental, or mixed purposes, rules abound.

By Kathryn Zdan, EA
Editor

Taxpayers who rent out a second home will treat it, for tax purposes, differently depending on if the home is used partially as a personal residence or exclusively as a rental.

In general, if the taxpayer uses the home for personal purposes for more than a *de minimis* amount of time, deductions are calculated under the vacation rental rules of IRC §280A. If the property is used exclusively as a rental, then the passive activity rules apply.

Vacation rental

The vacation home rules apply if a taxpayer uses the property as a residence. A taxpayer uses a property as a residence if he or she uses the property for personal purposes during the taxable year that exceeds the greater of:

- 14 days; or
- 10% of the total days it was rented to others.

Rental deductions for vacation home rentals are limited to the amount of rental income. Any deductions that cannot be claimed may be carried over to future years.[1]

Deductions must be claimed in the following order for the following amounts:[2]

1. Expenses directly related to the rental (e.g., advertising, commissions, etc.) — 100% deductible subject to income limitations;
2. Interest and taxes — Deductible as rental expense *pro rata*: days rented over days in year subject to limitations; balance deductible on Schedule A;
3. Operating costs that do not affect basis — Deductible as rental expense *pro rata*: days rented over days used; and
4. Depreciation — Claimed for the rental portion of the home or for the days of the year the entire home was rented.

Expenses allocable to personal use of a second home are deductible on Schedule A, but the taxpayer is subject to the $10,000 state and local tax limitation put in place by the TCJA for all personal use properties.

Example of allowable deductions for a vacation rental: Robert lives in his San Diego condominium for 200 days during the year. He rents it out for 100 days and brings in $10,000 of rental income. The property was used as a rental for 27% of the year (100 days rented ÷ 365 days in the year) and for 33% of the amount of the total time used (100 days rented ÷ 300 days used). Therefore, Robert can deduct on Schedule E 27% of his mortgage interest and property taxes and 33% of his general expenses, up to the amount of rental income he earned from the condo during the year, which was $10,000.

During the year, Robert incurs the following rental-related expenses:

- Direct expenses: $2,000
- Mortgage interest: $20,000
- Property tax: $6,000
- General expense: $6,000
- Depreciation: $4,000

Applying the ordering rules discussed above, Robert may claim the following deductions on Schedule E:

- $2,000: Direct expenses (100% of expenses may be claimed up to the rental income received);
- $7,200: Mortgage interest and property taxes (27% × $26,000 of total interest and taxes). The remaining $18,800 is itemized deduction reportable on Schedule A, but subject to the limitation on state and local income taxes; and
- $800: General expenses.

The general expenses are capped at $800 because Robert's deductions are capped at the $10,000 rental income he received for the year. However, he may carry over $1,180 in general expenses ($6,000 × 33% = $1,980 − $800 claimed this year) and the $4,000 in depreciation he was unable to claim.

Limited rental use

If a taxpayer uses the property as a residence and rents it out for 14 days or less during the year, the taxpayer is not required to report the rental income and is not permitted to claim any deductions related to the rental use.[3]

100% rental use

A property is treated as residential rental property when it is rented at fair rental value, and personal use by the owner does not exceed the 14 days/10% rules covered above.

However, now the passive loss rules come into play.[4]

When a property is treated as a residential rental, generally income and deductions are automatically treated as passive in nature — unless the owner qualifies as a real estate professional and meets one of the material participation tests for the rental property at issue.[5]

If the rental generates more deductions than income, any loss may generally only offset other passive income — again, unless the taxpayer is a real estate professional and meets one of the material participation tests for the rental property at issue.

However, if the taxpayer actively participates in the rental activity and AGI doesn't exceed $100,000, then the taxpayer may offset nonpassive income with up to $25,000 of the rental income. This $25,000 allowance begins to phase out when AGI exceeds $100,000 and is completely phased out at $150,000 of AGI.[6]

Note: The active participation tests are less strict than the requirements for material participation.

Room rentals

In certain instances, the rental of a room or a residence may be treated as a hotel or a bed and breakfast, which means the taxpayer must treat the rental as a trade or business. This applies in situations where a room or a residence is regularly made available for occupancy by paying customers and isn't used by an owner as a "home" during the year.[7]

If the taxpayer also provides substantial services such as regular cleaning, breakfast or other meals, changing linen or maid service, it will be treated as a bed and breakfast.

Taxpayers who fall into this category must report the income on a Schedule C if a sole proprietor and must pay self-employment taxes on the income. However, the deduction limitations discussed above do not apply.

Days of use

A taxpayer is considered to have used a dwelling unit for personal purposes on any day if, for any part of the day, the unit is used by:[8]

- The taxpayer or any other person who owns an interest in the unit;
- The taxpayer's family members, including a spouse, sibling, half-sibling, lineal ancestor, or lineal descendant;
- Anyone who uses the unit under a reciprocal agreement ("I use your place, you use mine"); or
- Any other individual who uses the unit without paying fair rental.

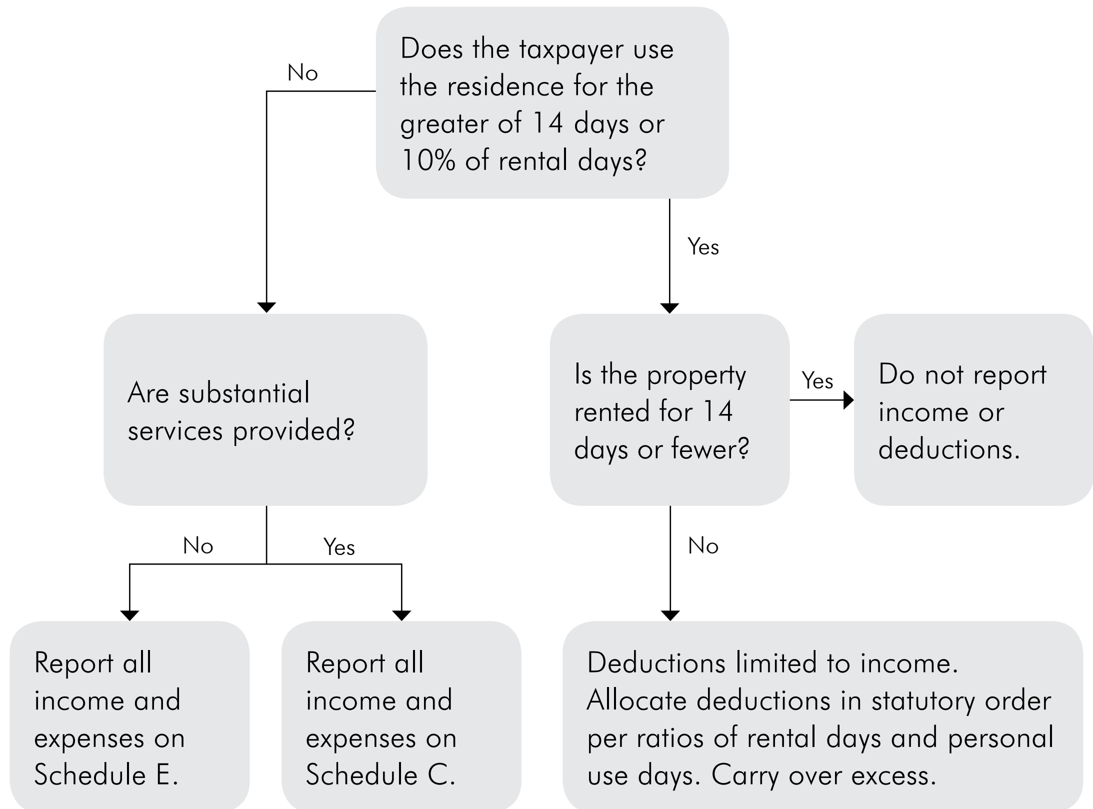
A day spent cleaning, repairing, or otherwise maintaining the property is not a day of personal use. Any day that the unit is donated for charitable use is counted as a personal use day.

Rental use treatment applies as follows:[9]

- Any day the unit is rented at a fair rental price is a day of rental use even if the host used the unit for personal purposes that day. This rule does not apply when determining whether the host used the unit as a home; and
- Any day the unit is available for rent but not actually rented is not a day of rental use.

See the following Vacation Home Flowchart to see where to report income.

Vacation Home Flowchart



1 IRC §280A

2 Prop. Treas. Regs. §1.280A-3(d)(3)

3 IRC §280A(g)

4 IRC §469(c)(7)

5 *Id.*

6 IRC § 469(i)(3)(A)

7 IRC §280A(f)(10(B); Prop. Treas. Regs. §1.280A-1(c)(2)

8 IRS Publication 527, Residential Rental Property (Including Rental of Vacation Homes)

9 *Id.*

NEWS BRIEFS

SSDI includable in income — A taxpayer unsuccessfully argued that her SSDI benefits were distinguishable from regular Social Security benefits and therefore were excludable from income under IRC §104(a).[1] SSDI is included in the definition of "Social Security benefits" found in IRC §86(d). The taxpayer was therefore required to include in income the SSDI, of which 85% was taxable.

1 ***Palsgaard and Kelly v. Comm.***, TCM 2018-82

Time to renew ITINs — Taxpayers with expiring ITINs should submit their renewal applications as soon as possible if they must file a tax return in 2019.[2] The IRS is now accepting ITIN renewal applications for:

- ITINs that have not been used on a federal tax return at least once in the last three consecutive years; and
- ITINs with middle digits 73, 74, 75, 76, 77, 81, or 82 that will expire at the end of the year (even if these taxpayers have used their ITIN within the last three years).

ITINs with middle digits of 70, 71, 72, 78, 79, or 80 have already expired. Taxpayers with these ITINs can still renew at any time.

The IRS will send a CP-48 Notice to affected taxpayers. Those who receive a CP-48 Notice after renewing their ITIN do not need to take action unless a family member is affected.

2 IRS Publication 5259, Fact Sheet — Expiring ITINs

Final *May Department Stores* regulations — The IRS has issued final regulations under IRC §§337(d) and 732 addressing transactions in which a corporation transfers appreciated property to a partnership that owns an interest in the corporation.[3]

The "May Company Regulations" were issued in response to a transaction engaged in by May Department Stores in the 1980s.[4] These regulations generally require a certain percentage of gain to be recognized when a corporation that is a partner in a partnership contributes appreciated property to a partnership and receives an interest in its stock. The final regulations provide for an exception when all the stock of the partnership is owned by corporate partners who are all members of the same affiliated group.[5]

3 T.D. 9833

4 ***May Department Stores Co. v. United States*** (1996) 36 Fed. Cl. 680; Rev. Rul. 99-40

5 See IRC §1504

Dispensary's expense deductions still not allowed — On appeal, a Colorado dispensary's arguments that IRC §280E violates the Eighth and Sixteenth Amendments fell short.[6] IRC §280E prohibits a deduction for any amount for a trade or business that consists of trafficking in controlled substances (e.g., controlled substances within the meaning of Schedule I — such as marijuana — and II of the Controlled Substances Act).

The taxpayer had originally argued that the IRS, in denying business expense deductions under IRC §280E, went beyond its jurisdiction and was effectively conducting a criminal investigation, and the IRS didn't have the authority to make the determination of whether a taxpayer was engaging in illegal activities for the purpose of applying IRC §280E.[7]

6 ***Alpenglow Botanicals, LLC v. U.S.*** (July 3, 2018) U.S. Court of Appeal, Tenth Circuit, Case No. 17-1223

7 ***Alpenglow Botanicals, LLC v. U.S.*** (December 1, 2016) U.S. District Court, District of Colorado, Case No. 16-cv-00258-RM-CBS

Medical expense deduction for weight loss program — The IRS considers obesity a disease for purposes of IRC §213,[8] and therefore amounts paid for participation in a weight loss program as treatment for obesity are deductible expenses for medical care. Taxpayers were denied deductions for a weight loss treatment program that cost them over $16,000 because they didn't have the requisite receipts to substantiate the expense.[9] The taxpayers were both diagnosed with obesity and were considered prediabetic and entered into a supervised health program. The IRS disallowed their medical expense deduction because the taxpayers didn't have proper receipts, only a handwritten list of payments and dates.

8 Rev. Rul. 2002-19

9 ***Fiedziusko v. Comm.***, TCM 2018-75

Church summons OK in audit of pastors — Taxpayers argued that the IRS conducted an improper audit of a church when the IRS requested records from the church relating to the pastors, who were the taxpayers under audit.[10] The taxpayers felt the IRS was overreaching,

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but considering the exchange of funds back and forth between the taxpayers' and the church's bank accounts and the taxpayers' signatory authority over church accounts, the IRS had the authority to make such a request. The Church Audit Procedure Act limits the manner in which the IRS can conduct investigations of churches; however, the statute restricts church tax inquiries and examinations, not all investigations that involve a church.[11]

[10] ***Rowe v. U.S.*** (May 16, 2018) U.S. District Court, Eastern Dist. of Louisiana, Case No. 18-75

[11] IRC §7611

Property manager is employee — The property manager of an apartment complex was an employee, rather than an independent contractor, of the LLC that owned the complex.[12] In looking at the factors that establish an employer–employee relationship, the court found that the property manager was clearly an employee. Among other factors that were met, the LLC had the right to control or direct the work the individual was to perform at the apartment complex, including how the individual would go about doing that work, and the LLC also owned and/or provided the facilities and most of the equipment that the individual used. The LLC did not qualify for relief under Section 530 because it never issued the property manager a 1099.

[12] ***Hampton Software Development, LLC v. Comm.***, TCM 2018-87

Upcoming due dates

September 15

Extended due date for partnership (Form 1065) and S corporation (Form 1120S) returns

Individual and corporate estimated tax payments due

Due date for June 30 fiscal year C corporations (prior to January 1, 2026)

Extended Due Date for Annual Information Return of Foreign Trust with a U.S. Owner (Form 3520-A)

Due date for S corporations and employer SIMPLE and SEP contributions

September 30

Due date for fiduciary returns