Individual Tax Issues – Part 1

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2023 National Income Tax Workbook™

Land Grant University

Tax Education Foundation, Inc.

Individual Tax Issues - Part 1

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- **Issue 1: Casualty Losses**
- **Issue 2: Disaster Relief**
- **Issue 3: Digital Assets**
- **Issue 4: Home Mortgage Interest Deduction**

ISSUE 1: Casualty Losses

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- **2023 Federally Declared Disaster Areas**
  - Alabama
  - California
  - Georgia
  - Mississippi
  - New York

ISSUE 1: Casualty Losses

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Casualty Loss Definition:

- A **<u>sudden</u>**, **<u>unexpected</u>**, and **<u>unusual</u>** event that causes damage or destruction of property

  - SUDDEN - Event is swift, not gradual or progressive
  - UNEXPECTED - Event is ordinarily unanticipated and unintended
  - UNUSUAL - Event is atypical, and not a day-to-day occurrence

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Progressive Deterioration is **NOT** a Deductible Casualty Loss

WHY?

- Because the damage results from a **steadily operating cause** or **normal process** rather than a sudden event

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Personal Use Property Loss

- Generally, a taxpayer **cannot** deduct personal expenses (IRC 262)

EXCEPTION

- Losses of personal use property **may** be deductible if losses are the result of fire, storm, shipwreck, or another casualty; or theft

For 2018-2025

- Deduction for personal casualty and theft losses is **LIMITED** to losses attributable to federally declared disasters

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Business Casualty Loss

- When disaster damages property held for business or income-producing purposes
  - $ 100-per-event rule & 10%-of-AGI limitation - Does **NOT** apply!
  - Loss does **NOT** have to be attributable to a federally declared disaster

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Calculating a Loss

- Lesser of Property's
  - Adjusted tax basis, OR
  - Decrease in its fair market value (FMV)
- Reduced by
  - Amount of insurance proceeds received
  - Casualty gains (if any)
  - Loss deduction limits

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Determining the Decrease in Value

- Difference between property's FMV **immediately before & immediately after** the casualty
- Treas. Reg. 1.165-7(a)(2) - Cost of repairs may, in certain cases, be used to measure decline in FMV
- Rev. Proc. 2018-8, 2018-2 I.R.B. 286 (safe harbors)
  - Not mandatory
  - IRS won't challenge determination if TP qualifies & uses one of the safe harbors

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Personal Use Residential Real Property definition:

- Real property, including improvements Such as buildings and ornamental trees and shrubbery
- Owned by TP who suffered casualty or theft loss
- Containing at least one personal residence

- **Excludes**
  - Personal Residence if any part is used as:
    - Rental property, or
    - Has a home office used in a trade or business

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- **Available Safe Harbors**
  - Estimated Repair Cost Safe Harbor
  - De Minimis Safe Harbor Method
  - Insurance Safe Harbor Method
  - Safe Harbor Methods for Federally Declared Disaster Areas

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Estimated Repair Cost Safe Harbor

- TP uses lesser of two repair estimates
- Prepared by 2 separate & independent contractors
  - Licensed/registered under state/local regulations
- Estimates must show itemized costs to restore the personal use residential real property to condition existing immediately prior to the casualty
- Available for casualty losses of $ 20,000 or less
  - Prior to application of the limitations under IRC 165(h) - ($ 100 reduction and 10%-of-AGI floor)

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De Minimis Safe Harbor Method

- TP determines decrease in FMV of personal use residential real property by estimating cost of repairs required to restore property to condition existing immediately prior to the casualty
- Available for casualty losses $5,000 or less
  - Prior to application of the limitations under IRC 165(h)

ISSUE 1: Casualty Losses

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Insurance Safe Harbor Method

- TP determines decrease in FMV of personal use residential real property
- Uses estimated loss determined in reports prepared by their homeowners or flood insurance company

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Safe Harbor Methods for Federally Declared Disasters:

1. **Contractor Safe Harbor Method –**
   - Licensed contractor specifies cost of repairs

2. **Disaster Loan Appraisal Safe Harbor Method –**
   - TP uses an appraisal that was prepared for a federal loan or loan guarantee

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Personal Belongings

- Item of tangible personal property owned by the individual who suffered a casualty or theft loss **NOT** used in trade/business or transaction entered for profit
- **Does not include:** Boat, aircraft, mobile home, trailer, vehicle, or antique or other asset that maintains/increases its value over time
- Determine pre-disaster value by consulting established pricing sources (“Blue Book” values)

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Personal Belongings

- **Allows Two Safe Harbors:**

  1. De Minimis Safe Harbor

     - Keep records of items and how you established the loss
     - Casualty losses $5,000 or less prior to application of the limitations under IRC 165(h)

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Personal Belongings

- **Allows Two Safe Harbors cont'd:**

  2. Replacement Cost Safe Harbor Method

     - Current replacement cost discounted by 10% for each year owned
     - If destroyed or stolen, FMV after disaster is zero

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Proof of Loss

- Must document **all** of the following:
  - Type of casualty and when it occurred
  - Loss was direct result of casualty
  - TP owned the property
    - If leased, TP was contractually liable to owner for the damage
  - A reasonable expectation of recovery from a claim for reimbursement

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Loss Deduction Limits – IRC § 165(h)

- Loss on personal use property reduced by:
  - $ 100 for each separate casualty, then
  - 10% of the taxpayer's AGI from the sum of all personal casualty losses incurred during year
- Report on Schedule A (Form 1040)
  - No tax benefit from casualty loss if total itemized deductions less than standard deduction

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Losses Offset Gains

- TP with personal casualty gains can deduct personal casualty losses **not attributable** to a federally declared disaster to extent loss does not exceed the gains
- Any remaining casualty gains then reduce casualty losses attributable to federally declared disasters, if applicable

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Example 6.3

- Sam has the following in 2023:
  - $10,000 personal casualty loss (Not due to federal disaster) – No reimbursement
  - $16,000 personal casualty gain
  - $20,000 personal casualty loss due to federal declared disaster – No reimbursement
  - AGI = $85,000
- What is Sam's gain or loss?

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Example 6.3

- Step 1 – offset gain by personal casualty loss (Not due to federal disaster)
  - $16,000 - $9,900 ($10,000 - $100) = $6,100 personal casualty gain
- Step 2 – reduce personal casualty loss due to federal declared disaster by remaining gain
  - ($20,000 - $100) - $6,100 gain - ($85,000 x 10%) = $5,300 deductible casualty loss

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Calculating a Casualty Gain

- Insurance proceeds > adjusted tax basis in the property at the time of the casualty
- If gain realized, gain **deferred** under **involuntary conversion** rules – Reinvests proceeds in similar or related in use to the destroyed property w/2 years
- If located in a federally declared disaster area, replacement period is extended to 4 years for loss of TP’s main home and contents.
  - Nonrecognition of gain is mandatory if property is involuntarily or compulsorily converted

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Example 6.4

FIGURE 6.1
Statement re Deferral of Casualty Gain

Deferral of Casualty Gain under I.R.C. § 1033

On January 12, 2023, Jenna Silverstein realized a casualty gain from the collapse of a garage caused by a tornado. The taxpayer postpones this casualty gain and has purchased replacement property that is similar or related in use as follows:

Insurance proceeds received	$35,000
Adjusted tax basis	(15,000)
Gain realized	$20,000
Gain deferred	(20,000)
Gain recognized	$ 0

Cost of replacement property (garage)	$45,000
Gain deferred	(20,000)
Basis of replacement property	$25,000

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Reporting Casualty Losses and Gains

- Section A of Form 4684
  - *Casualties and Thefts*
- Net loss is an ordinary deduction under IRC 165
  - Deducted on Schedule A (Form 1040)
- Net gain is a capital gain
  - Reported on Schedule D (Form 1040)

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Multiple Casualties during Year

- Calculate losses separately for **each** event
- Each reduced by any reimbursement and by $100
- Combined losses reduced by 10% of AGI

Mixed-Use Property

- Calculate loss deduction **separately** for each portion
- Allocate adjusted basis & FMV before and after loss
- Allocate insurance or other reimbursement
- Apply $100 & 10%-of-AGI limitations **only on personal use portion**

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Timing and Deductibility of Losses

- Generally, deductible only in year of occurrence.
- In federally declared disasters can deduct losses in:
  - Tax year disaster occurred OR preceding year
  - Election made on Form 4684 (Schedule D)
  - Rule applies to both personal and business losses

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Actual Reimbursement Less than Expected

- If received in a later year - Include the difference as a loss on the return for year in which the taxpayer expects no additional reimbursement

- **Actual Reimbursement More than Expected**
  - If received in a later year and claimed a loss deduction in a prior year - Include extra reimbursement in income in the year the taxpayer receives the reimbursement

ISSUE 1: Casualty Losses

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Temporary Living Expenses

- If TP cannot use home following a casualty
  - Can exclude insurance reimbursements for the additional living expenses from income
    - Subtract normal living expenses from actual living expenses incurred
- Living expenses include:
  - Rent, meals, utilities, transportation, and miscellaneous services such as laundry

ISSUE 2: Disaster Relief

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Generally, disaster relief occurs when a Governor of a state, requests assistance & President declares an area to be eligible for Federal Assistance.

- Under Robert T. Stafford Relief & Emergency Assistance Act
- Disaster relief payments under this Act may be taxable or may be excluded from income

ISSUE 2: Disaster Relief

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Disaster Relief Payments

- Typically limited to payments to individuals
- Payments can be in the form of:
    - Grants
    - Loan cancellation
    - Qualified disaster relief payments
    - Qualified disaster mitigation payments

ISSUE 2: Disaster Relief

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Grants

- Excluded from gross income if:
  - Made to meet necessary expenses OR
  - Serious needs for medical, dental, housing, personal property, transportation, or funeral expenses
- Cannot deduct a casualty loss or medical expense to extent loss or expense is reimbursed by the grant

ISSUE 2: Disaster Relief

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Federal Loan Canceled

- Debt forgiveness is reimbursement for the loss

AND

- Reduces casualty loss deduction

ISSUE 2: Disaster Relief

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Qualified Disaster Relief Payments

- Excluded from income from **ANY** source in tax year ending on or after **September 11, 2001**
- Qualified payments include payments received:
  - As a result of federal declared disaster
  - For unreimbursed expenses which are **reasonable and necessary** such as:
    - Personal, family, living, or funeral expenses
    - Repair or rehabilitation of personal residence
    - Repair or replacement of contents of personal residence

ISSUE 2: Disaster Relief

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Qualified Disaster Mitigation Payments

- Excluded from income if paid under:
  - Disaster Relief Act or National Flood Insurance Act
  - To protect the property from future disasters, rather than provide relief afterwards
    - Does not apply to amounts received for Sale or disposition of property
    - Excluded amounts DO NOT increase basis

ISSUE 2: Disaster Relief

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Postponed Tax Deadlines

- IRS may postpone for **up to 1 year** most tax deadlines for taxpayers impacted by federally declared disaster
- Includes:
  - Filing all federal tax returns, including claims for refund
  - Paying income, gift, and estate taxes
  - Making contributions to a traditional or Roth IRA

NOTE: What is not covered in the list above?

- Payment of employment taxes!!!

ISSUE 2: Disaster Relief

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General Rules

- IRS publicizes postponed tax deadlines in affected areas
- 2023 relief (as of July 2023) is available for taxpayers in:
  - Alabama, Arkansas, California, Georgia, Indiana, Mississippi, New York, Oklahoma, and Tennessee
  - Visit www.irs.gov/newsroom/tax-relief-in-disaster-situations for an update

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Affected TPs eligible for additional time to file include:

1. Individual whose principal residence is located in covered disaster area (CDA)
2. Business entity or sole proprietorship whose principal place of business is located in CDA
3. Individual who is a relief worker affiliated with a recognized government or philanthropic organization and who is assisting victims in CDA
4. Individual, business entity, or sole proprietorship whose records that are needed to meet a postponed deadline are maintained in CDA

ISSUE 2: Disaster Relief

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Affected TPs eligible for additional time to file include, cont'd:

5. An estate or trust that has tax records necessary to meet a postponed tax deadline provided those records are maintained in a CDA
6. Spouse filing joint return with taxpayer eligible for postponement
7. Any individual visiting the CDA who was killed or injured as a result of the disaster
8. Any other person who the IRS determines to be affected by federally declared disaster

ISSUE 2: Disaster Relief

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Practitioner Note - Preparer in Disaster Area

Taxpayers outside of the disaster area may qualify for relief if their tax return preparer is located in the disaster area, and the preparer is unable to file or pay on their behalf. To receive the postponement for filing or payment, the taxpayer can call the Disaster Hotline at 866.562.5227. The taxpayer should explain that his or her necessary records are located in a covered disaster area and provide the FEMA Disaster Number of the area where the tax preparer is located.

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Retirement Plan Distributions

- Secure 2.0 Act provides permanent rules of use of retirement funds for federally declared disaster
- Allows $ 22,000 distribution to affected individuals
    - Not subject to 10% additional tax on early distribution
    - Included as gross income over 3 years
    - Distributions can be repaid
- Amounts distributed **prior to** disaster to purchase home
    - Can be recontributed
    - Allows TP to borrow an additional amount and have additional time for repayment

ISSUE 3: Digital Assets

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Reporting Digital Assets (aka Virtual Currencies)

2022 Form 1040, Page 1, Question

- At any time during 2022 did you receive (as a reward, award, or payment for property or services); or sell, exchange, gift, or otherwise dispose of a digital asset (or a financial interest in a digital asset)?

ISSUE 3: Digital Assets

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Reporting Digital Assets (aka Virtual Currencies)

- <u>Check the box "Yes" if the taxpayer:</u>
- Received digital assets as
  - Payment for property or services provided;
  - Result of a reward or award;
  - Result of mining, staking, and similar activities;
  - Result of a hard fork (branching & splitting blockchain into 2;
- Disposed of digital assets
  - In exchange for property or services;
  - In exchange or trade for another digital asset;
  - Sold a digital asset;
  - Transferred digital assets for free as a bond fide gift; or
  - Otherwise disposed of any other financial interest in a digital asset.

ISSUE 3: Digital Assets

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TP **has** a financial interest in a digital asset if:

- TP is owner of record of a digital asset
- TP has an ownership stake in an account that holds one or more digital assets
  - Including the rights and obligations to acquire a financial interest
- TP owns a wallet that holds digital assets

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Check the box “No” if the taxpayer:

- Merely owned digital assets during the year
  - As long as he or she did not engage in any transactions involving digital assets during the year
- Activities were limited to one or more of the following:
  - Holding a digital asset in a wallet or account
  - Transferring a digital asset from one wallet/account the taxpayer owns or controls to another
  - Purchasing digital assets using US or other real currency, including through the use of electronic platforms such as PayPal or Venmo

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For 2023 - If TP disposes of any digital asset held as a capital asset through sale, trade, exchange, payment, gift, or other transfer:

- Check “Yes” box
- Report the transactions & calculate gain/loss on F8949, *Sales and other Dispositions of Capital Assets*
    - Report on Schedule D (Form 1040)
    - F709, *US Gift Tax Return (for gifts)*

ISSUE 3: Digital Assets

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IRS delays Cryptocurrency Reporting

PRACTITIONER NOTE

IRS Delays Cryptocurrency Reporting

The IRS delayed the requirement that brokers report or furnish additional information with respect to dispositions of digital assets. The reporting rules for digital assets were originally scheduled to take effect for returns or statements required to be filed or furnished after December 31, 2023 (2023 transactions). Until the IRS issues final regulations, a broker may report gross proceeds and basis as required under existing law.

ISSUE 3: Digital Assets

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No Loss Deduction for Decline in Value

- IRC §165 provides for deduction of losses
- Loss allowed as a deduction only for year sustained
  - Evidenced by closed and completed transactions, and
  - Fixed by identifiable events
- Generally deducted as miscellaneous itemized deduction but IRC 67(g) disallows ALL miscellaneous itemized deductions for tax years 2018 through 2025

ISSUE 3: Digital Assets

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Loss Due to Worthlessness – IRC § 165(g)

- If any security that is a capital asset becomes worthless during the tax year:
  - Loss is treated as a loss from the sale or exchange of a capital asset
  - Cryptocurrency is **NOT** a security so IRC § 165(g) does not apply

ISSUE 3: Digital Assets

Loss Due to Abandonment

- Under IRC § 165(a), a TP sustains a loss for the obsolescence or loss of usefulness of nondepreciable property if:
  - Loss is incurred in a business or transaction entered into profit;
  - Loss arises from sudden termination of usefulness in the business or transaction; and
  - Property is permanently discarded from use, or the transaction is discontinued

ISSUE 3: Digital Assets

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Charitable Contribution of Cryptocurrency

- Is TP required to obtain a qualified appraisal for donation of crypto where they claimed a charitable contribution deduction of more than $ 5,000?

- Generally qualified appraisals are not required for donations of certain readily valued property such as:
  - Cash, stock in trade, inventory, property held primarily for sale to customers in the ordinary course of business, publicly traded securities, intellectual property, and certain vehicles

- Cryptocurrency is **NOT** cash or a security
  - *Therefore, qualified appraisals are required*

ISSUE 3: Digital Assets

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Nonfungible Tokens (NFT)

- Treasury Department & IRS are soliciting feedback regarding tax treatment of a NFT as a collectible
- So until additional guidance is issued:
  - IRS will use **look-through analysis (LTA)** to determine if an NFT is to be treated as a collectible
  - Under LTA, we look to see if the NFT's associated right or asset falls under the definition of a *collectible*
    - Example: A gem is a collectible; therefore, an NFT that certified ownership of a gem is deemed a collectible

Thank you