2023
National Income Tax Workbook

Chapter 6: individual tax issues Part 1

Land Grant University
Tax Education Foundation

Learning Objectives P 193

- Understand when a taxpayer can claim a loss for a personal casualty
- Calculate the amount of a casualty loss
- Know how to apply the casualty loss deduction limits
- Know how to report a casualty loss
- Understand the taxation of disaster-related provisions
- Know the types of relief that are available to disaster victims

Learning Objectives P 193

- Comply with the digital asset reporting requirements
- Explain new reporting requirements for certain digital asset transactions
- Know when a taxpayer can claim a loss for worthless digital assets
- Understand when a taxpayer can claim the home mortgage interest deduction
- Calculate the limits on the home mortgage interest deduction

What is a Casualty Loss P 195

- Sudden
- Unexpected
- Unusual
- Swift
- Results in material damage to: people, property and or business
- Generally, out of your control

Personal vs Business Property P 195

- Personal – generally not deductible (2018 – 2025)
- Business – may be deductible

- Property held for business or for income-producing purposes
- Does not need to be a Federally Declared Disaster (FDD)

Calculating a Loss P 196

- Determine the decrease in FMV
- FMV before vs FMV after
- Loss deduction limited to the actual loss from damage
- Cost of repairs may be used (if actually made)

1. Safe Harbor (personal use residence, belongings)
2. Safe Harbor (occurring in a FDD area)
3. Insurance Safe Harbor Method

Repair Safe Harbor Qualification P 196

- Personal Use residence (no part rented or home office) does not include condo, co-op, mobile home or trailer
- Must it be in a Declared Disaster Area?
- Lesser of – two estimates by two separate independent licensed contractors
- Must be itemized to restore residence to prior condition
- Any improvements can not be included (even if required)
- Only available to losses of $20,000 or less (4 cans of paint)

De Minimis Safe Harbor Method   P 196

- TP uses decrease in FMV by estimating cost of repairs
- Estimate must be a **Good Faith** estimate
- TP must keep records to show method used
- Limited to losses of $5,000 or less (2 can of paint)
- Both Safe Harbor methods are considered before the $100 & 10% AGI reductions

Safe Harbor Methods for Federally Declared Disasters P 197

- TP determines loss using the Contractor Safe Harbor method or
- Disaster loan method – using an appraisal prepared for a federal disaster loan guarantee
- These methods are for the residence only not personal belongings
- Personal belongings – owned by you & not used in a trade or business or in a transaction entered into for profit
- No boats, aircrafts, mobile homes, trailers, vehicle, antique, or collectable
-

De Minimis safe Harbor Method P 197

- TP makes a **good faith** estimate of decrease in FMV of personal belongings
- Keep your records on how this was computed
- Limited to losses of $5,000 or less

Replacement Cost Safe Harbor Method P 197

- Starts with replacement cost – reduce by 10% for each year owned
- Belongings owned 9 years or more = 10% of replacement cost
- TP then subtracts post-disaster FMV from pre-disaster FMV
- If belonging was totaled or stolen FMV used is zero
- FMV is zero if item is destroyed or stolen

Proof of Loss P 197

- The type of casualty and when it occurred
- That the loss was a direct result of the casualty
- Prove that the taxpayer owned the property
- Whether there is a reasonable expectation of recovery from a claim for reimbursement

- How do you prove something existed after several years
- Insurance policy
- Photos

Loss Deduction Limits P 198

- Losses must be reduced by the following

1. $100 per casualty event
2. 10% of AGI (after $100 reduction)

- Reported on Schedule A
- If the TP can't itemize – no deduction allowed elsewhere - except

Loss Deduction Limits

P. 198

P. 198

- **Practitioner Note**
  - Qualified Disaster Losses - Specified 2020-2021 disasters

- **Losses Offset Gains**
  - Taxpayer with personal casualty gains can deduct personal casualty losses **not attributable** to a FDD
    - To extent loss does not exceed the gains

Example 6.1 P 198

- 2023 - Sam had a $10,000 personal casualty loss (not in a FDDA)
- Damage was not covered by insurance
- He had no other casualty gains
- Can Sam claim a casualty loss?

Example 6.2 Page 198

- Same facts as in example 6.1
- Plus, Sam also had a $16,000 personal casualty gain

Q. Can Sam claim a casualty loss?

- Sam can reduce his gain by the $10,000 loss (after the $100 reduction)
- Sam's net casualty gain is $6,100

Example 6.3 P 198

- June 2023 – Sam has a $20,000 personal casualty loss in a FDDA
- Sam's AGI for 2023 was $85,000
- Sam had a $16,000 personal casualty gain
- No reimbursement from insurance

($20,000 - $100 = $19.900) - $8,500 AGI = $5,300 deductible loss on Schedule A

Can You Have a Casualty Gain? P 199

- Insurance (full replacement)
- Basis may be lower than insurance reimbursement
- Gain is deferred (mandatory under involuntary conversion rules)
- TP can replace property with similar or related property within 2 years (4 years for residence if located within a FDDA)

Example 6.4 P 199

- 2023 – Tornado destroyed Jenna’s garage
- Basis $15,000
- Received $35,000 insurance proceeds
- Spent $45,000 to replace garage (no improvement)

Figure 6.1 P 199

Insurance proceeds received	\$35,000
Adjusted tax basis	(\$15,000)
Gain realized and deferred	\$20,000
Gain recognized	\$ 0
Cost of replacement property (garage)	\$45,000
Gain deferred	- 20,000
Basis of replacement property	**\$25,000**

Example 6.5 P 200

- 2023 - C & M Brown suffered a personal casualty in a FDDA
- 2023 AGI $157,998
- Personal residence and personal contents suffered losses
- Figure 6.2 breaks down Home & related land scaping from personal belonging as well as a camper
- Each loss is computed separately based on pre and post FMV less insurance proceeds and reported on Form 4684
- The loss is further reduced by $100 and 10% of AGI $15,808

Multiple Causalities During the Year   P 203

- Multiple casualties may allow TP to claim a loss that otherwise would not meet the 10% AGI threshold
- Mixed use property (personal & business/income producing)
- Need to calculate each portion separately
- Allocate the adjusted basis & FMVs & insurance proceeds
- The $100 & 10% AGI floors only apply to personal portion
- For FDDA a TP may claim an allowable loss in the year it occurred or prior year

Selecting When to Claim the Loss P 204

- Two Options: Year of FDD or Prior year
- Consider the value of the $$$$ now or wait until you file
- Need to consider AGI & expected AGI for each year
- Election on Form 4684 Section D
- (Prior year) election on or before the date that is 6 months after the due date (excluding extensions) for the year of the disaster (10/15/XX) of the loss year
- Estimate insurance used – any adjustment is on the return of the year the TP receives the funds (no amended returns)

Temporary Living Expenses P 204

Principle Residence in Disaster Area P 204

- What about contents?
- No gain is recognized for unscheduled property (for now)
- Four-year grace period to replace property
- Any excess insurance proceeds become taxable
- Unscheduled – not specifically listed (ring, painting…)

Disaster Relief P 205

- Disaster Relief payments – limited to individuals in the form of grants, loan cancellations, qualified disaster relief payments or mitigation payments
- Grants – not taxable (can not be duplicated with a casualty loss)
- Unemployment payments – taxable
- Cancelled disaster loans – not taxable but reduces casualty loss
- Qualified disaster relief payments – not taxable (from any source) and be in the form of living expense, repair expenses, replacement of personal belongings

Disaster Relief P 206

- Qualified Disaster Mitigation Payments – not taxable (funds to protect from future disasters) but could increase basis in property
- Postponed Tax Deadlines – all federal tax filings up to 1 year, abatement of interest and penalties
  - *Done through a Rev Ruling, Rev Procedure, notices, announcement, IRB*
- State Relief - may apply to certain states (check you state web site)

Tax Deadlines P 206

1. Individual – principal residence located in covered disaster area
2. Business – principal place of business located in covered disaster area
3. Relief Worker – who is assisting in a covered disaster area
4. Business – whose tax records are maintained in a covered disaster area
5. Estate or Trust – where tax records are maintained in a covered disaster area

Tax Deadlines P 207

6. Spouse – if filing MFJ with an eligible TP
7. Any Individual – killed or injured as a result of a covered area
8. Any Other Person – determined by the IRS to be affected by a FDD

What about my records with my tax preparer?

Yes, if your records were in a covered area. You would need to call the Disaster Hot Line @ 866 562-5227 (have the FEMA Disaster Number)

Retirement Plan Distributions P 207

- SECURE 2.0 Act – makes permanent the use of retirement funds for a FDD
- For employer plans or IRAs to distribute up to $22,000 to affected TPs
- No 10% early withdrawal penalties
- Included in gross income ratably over 3 years
- Distributions can be repaid
- Amounts distributed prior to the disaster to purchase a home can be recontributed, and an employer can allow affected individuals to borrow an additional amount and allow additional time for repayment of plan loans.

Digital Assets P 208

- Reporting of digital assets on 1040
- IRS recent guidelines
- "***Digital Asset***" replaces "***Virtual Assets***"
- Digital Asset – any digital representations of value that are recorded on a cryptographically secured distribution ledger or any similar technology (nonfungible tokens, virtual currencies, stablecoins)

Reporting Digital Assets P 208

How did you answer this question on your 2022 1040?

- 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)?

Did you read the instructions?

Check the Yes box next to the question on digital assets if the taxpayer:

Digital Assets P 208

- There are 9 questions in the instructions that if answered “Yes” would most likely cause you to report a gain or loss on the receipt, sale, exchange, transfer or otherwise disposed of an interest of a digital asset.

Just Say "No" P 208

- A taxpayer who merely owned digital assets during the year can check the "No" box as long as the taxpayer did not engage in any transactions involving digital assets during the year

- The taxpayer can also check the "No" box if his or her activities were limited to one or more of the following:
- Holding
- Transferring between wallets/accounts

Reporting Digital asset Income P 209

- Form 8949 – Sales and other Dispositions of Capital Assets
- Schedule “D”
- Form 709 - Gift Tax Return
- W-2 (received or paid for services with digital currency)
- 1099 - (received or paid for services with digital currency)

IRS Delays Some Crypto Reporting   P 209

- The IRS delayed the requirement that brokers report or furnish additional information with respect to dispositions of digital assets until final Regs are issued

Losses Due to Decrease in Value P 209

- Just like a stock (IBM, GE) – no loss deduction until disposed of
- Worthlessness – no deduction if still traded on at least one Crypto exchange
- Sales, exchanges, dispositions may result in recognition of gain or loss
- Character depends on if the property is a capital asset in the hands of the TP
- IRC 165 - provides for the deduction of losses sustained during the tax year if not compensated by insurance or otherwise

Worthlessness or Abandonment P 210

- Crypto is not a security (IRC 165 does not apply) subjective determination of worthlessness in a given year
- Is there a liquidating value (any value)
- Will or could it increase in value
- See IRS memo 202302011

Charitable Contribution Of Crypto P 211

- IRS chief counsel memo requires an appraisal (IRC 170(f)) for donations of more than $5000
- As Crypto is a capital asset the exchange rate is not a valid method to determine FMV
- Not a security
- Is a NFT a collectable subject to capital gains tax – IRS is yet to issue a formal opinion
- TP claimed a $10,000 charitable donation & attached a partially completed Form 8283 (no attached appraisal)

Home Mortgage Interest Deduction P 213

- Mortgage interest rates have risen and continue to do
- So has the Standard Deduction ($27,700 for 2023)
- Salt tax limit is still $10,000
- Some states have work arounds that the IRS has not challenged
- IRC 163 also provides limits on loan amounts
- Loan amounts were reduced starting 1/1/2018 through 12/31/2025

Terms of Indebtedness P 213

- Acquisition indebtedness – debt incurred for acquiring, construction, or substantially improving any qualified residence
- Qualified residence – principal residence (IRC 121)
- Prior to 2018 and after 2025 – aggerated amount of acquisition indebtedness cannot exceed $1,000,000 MFJ and cannot exceed the FMV
- After 2017 and before 1/1/2026 TCJA limits amounts to $750,000 MFJ & $375,000 MFS

Qualified Principal Residence P 214

- Principal residence – spend most time & other factors
- Could include – house, condo, mobile home, boat, house trailer
- Generally, has – sleeping space, toilet, cooking facilities, second residence (defined & limited by IRC 280, not rented for the greater of 14 days or 10% of rental days)
- Special rules for married not filing joint

Example 6.8 P 214

- While Stan & Laurie were getting divorced Stan moved out
- Stan purchased a new home and borrowed $100,000
- Laurie continued to live in the home
- Stan still has a joint interest in his prior residence and is liable for the $200,000 mortgage
- Stan can treat his former residence as a second home

Secured Debt P 214

- Secured debt only includes interest paid or accrued <u>on</u> a qualified residence
- Includes – mortgage, deed of trust, or land contract and the debt instrument:

1. Makes the interest of the debtor in the qualified residence specific security for the payment of the debt;
2. States that, in the event of default, the residence could be subjected to the satisfaction of the debt with the same priority as a mortgage or deed of trust in the jurisdiction in which the property is situated; and …. continued

Secured Debt P 215

- 3. is recorded, where permitted, or is otherwise perfected in accordance with applicable state law

Who Can Claim the Deduction?   P 215

- Generally - The name on the mortgage and he/she pays the interest
- Tres Regs – allows deduction for interest paid by the TP, that the TP **legally or equitably** owns even if the TP is not directly on the note
- Courts have looked at 7 factors, [Blanche v. Commissioner, T.C. Memo. 2001-63

1. Who has right of possession
2. Who is responsible for maintain
3. Who is responsible for insuring property

Courts Considered 7 Factors P 215

4. Who bears the risk of loss?
5. Who is obligated to pay taxes, assessments, and charges against the property?
6. Can the taxpayer improve the property without permission from the owner of record?
7. Can the taxpayer obtain legal title by paying the balance of the purchase price?

Example 6.9 P 215

- Lisa, borrowed $300,000 and purchased a residence with her fiancé The loan was secured by the residence
- Lisa and her fiancé separated, her brother (Jesse) and Lisa agreed that Jesse would pay the remaining mortgage payments in exchange for a 50% interest in the residence.
- Jesse lived in the residence for several years and considered it his home.
- He paid the mortgage on the residence, was responsible for the mortgage, property taxes, and insurance, & had a 50% equitable ownership interest.
- Can Jesse claim the mortgage deduction?

More Than One Borrower P 216

- Form 1098 issued to one borrower
- Attach the 1098 to the return with an explanation
- Each TP deducts his/her share

I have seen Form 1098 with only one of two borrower's name