TAX NEWS

FALL 2017

Dear Client:

Congress and the White House have yet to agree on legislation which addresses the issues of the Affordable Care Act (aka Obamacare) and what tax law changes will be taking place this year.

One of the main issues concerns the treatment of debt forgiveness for your primary residence—whether it be an abandonment of the property or partial loan modification. Since 2007 this income has been exempt from tax under the Mortgage Debt Forgiveness Act, which expired at the end of 2016.

We are tracking what is happening with any potential tax legislation that may affect your tax liability for 2017.

In this newsletter we address how the forgiven debt is treated on your tax return in the event the Mortgage Debt Forgiveness Act is not reinstated.

We are also addressing some questions on tax provisions that we have received from you here in the office.

If you have any questions regarding the following topics or any other tax issues please be sure to contact our office.

Cancellation Of Debt-Insolvency

The Mortgage Debt Forgiveness Act, which treated the debt forgiven on your primary residence as nontaxable income, expired on December 31, 2016 and has not yet been reinstated by Congress—and may not be. If you had debt forgiveness from your mortgage company or had a loan modification that reduced the amount of the indebtedness then you may receive a notice for cancellation of debt.

Taxpayers with cancelled debt can often exclude the cancellation of debt income to the extent they were insolvent immediately before the cancellation. If a cancelled debt is excluded from income, it is nontaxable. Generally, cancelled debt that is excludable from income is debt that is discharged in a bankruptcy.

Cancellation of Debt

Cancellation of debt (COD) is settlement of a debt for less than the amount owed. A debt may be cancelled by a lender voluntarily or through bankruptcy or other legal proceedings and may result in ordinary income, income from the sale of assets (capital gain), or both.

Form 1099-A, Acquisition or Abandonment of Secured Property

If your lender foreclosed on your mortgage or repossessed property as a result of a defaulted loan then each borrower will receive Form 1099-A if, in full or partial satisfaction of the debt, they acquire an interest in the property. You need not be in the business of lending money to be subject to this reporting requirement.

Form 1099-C, Cancellation of Debt

If your lender cancels or forgives a debt of $600 or more, it must provide the borrower with Form 1099-C, showing the amount of cancelled debt to be reported as income. Generally, individual taxpayers must include all cancelled amounts, even if less than $600, as Other Income on line 21, Form 1040.

Cancelled Debt Situation	Tax Treatment
Debt owed by a taxpayer is cancelled or forgiven.	Amount cancelled or forgiven is generally taxable as ordinary income from cancellation of debt.
Property that is security for a debt is taken by the lender in full or partial satisfaction of that debt.	The transaction is treated as a sale of the property, which may result in a gain or loss.
Property that is security for a debt is taken by the lender, and lender cancels recourse debt in excess of FMV of property taken.	Excess of cancelled debt over FMV is ordinary income from cancellation of debt, in addition to any gain or loss from the sale.
Cancelled debt is intended as gift.	Amount cancelled is not income. Gift tax return may apply

Coordination Form 1099-A with Form 1099-C

If, in the same calendar year, a debt is canceled of $600 or more in connection with a foreclosure or abandonment of secured property, you may not receive both Form 1099-A and Form 1099-C, Cancellation of Debt, for the same debtor. You may receive Form 1099-C only.

Examples of COD Income

Nonbusiness credit card debt cancellation: if non-business credit card debt is cancelled, the taxpayer may be able to exclude the cancelled debt from income up to the extent he or she is insolvent.

Personal vehicle repossession: if the taxpayer had a personal vehicle repossessed during the year, the transaction is treated as a sale, and gain or loss on the repossession must be computed. If the lender also cancels all or part of the remaining debt, the taxpayer may be able to exclude the cancelled debt from income to the extent he or she is insolvent.

Taxpayer Insolvency

A taxpayer is insolvent to the extent that the total of all their liabilities exceeds the fair market value (FMV) of all their assets immediately before the cancellation of debt.

For purposes of determining insolvency, assets include the value of everything the taxpayer owns (including assets that serve as collateral for debt and exempt assets which are beyond the reach of creditors,

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Business Use of Home

expenses and substantiation issues in past newsletters. One of the more popular business expenses for home-based businesses is the home office deduction. The IRS code states that the space used for the home office must be used exclusively and regularly for the operation of the business. No other activity can be conducted in the home office to qualify for the tax deduction. If the taxpayer uses the room for any other purpose (such as a guest bedroom or place for students to prepare their homework) then the home office deduction is not allowed.

Some expenses are deductible whether or not a taxpayer uses his or her home for business. Others are deductible only if the home is used for business.

Deductible Regardless*	Deductible Only if for Business**
• Real estate taxes • Mortgage interest • Casualty losses • Qualified mortgage insurance premiums.	• Homeowner's insurance • Rent • Repairs and maintenance • Security system • Utilities and services • Depreciation (deductible after applying deduction limitation to above expenses)

** Deductible as an itemized deduction.*

*** Deductible as a business expense pro-rated for the amount of the business use of the home*

Direct Expenses

Expenses that benefit only the area exclusively used for business, such as painting or repairs in the home office, are direct expenses that are fully deductible.

Indirect Expenses

Expenses for keeping up and running the entire home, such as insurance, utilities, and general repairs, are indirect expenses that are deductible based on the percentage of the home used for business.

Unrelated Expenses

Expenses for the part of the home not used for business, such as lawn care or painting a room not used for business, are unrelated expenses that are not deductible.

Telephone

The basic local telephone service for the first telephone line is nondeductible even if it is used for business. Any additional charges for long distance or a second line into the home used for business are deductible. Any deductible telephone costs are not included as business use of home cost.

Depreciation

A qualified home office is considered non-residential real property depreciable over 39 years. For home office depreciation, the basis in the home is the smaller of:

- The fair market value (FMV) of the home minus the FMV of land on the date the home was first used for business, or
- The home's cost plus permanent improvements minus casualty losses minus the cost of land on the date the home was first used for business.

Home Improvements

Permanent improvements prior to using the home for business are added to the basis of the home and depreciated as part of the adjusted basis of the home. The cost of improvements made after using the home for business that affect the area of the home used for business are depreciated separately.

EXAMPLE: *Rita had a new roof put on her home in 2000. She first used her home for business in 2004. She also replaced her furnace in 2017. The cost of the new roof from 2000 is added to the basis of her home, and the business portion is depreciated starting in 2004. The business portion of the cost of the furnace is depreciated as a separate asset starting in 2017.*

Calculating Business Use of Home Deduction

Business Percentage

The business percentage equals the area of the part of the home used for business divided by the area of the whole house. Any reasonable method may be used to determine the business percentage.

The following are two common methods.

- Divide square footage of area used for business by total square footage of home.
- If all rooms are about the same size, divide the number of rooms used for business by total number of rooms in the home.

Part-Year Use

Do not include home expenses in the business use equation for any period during the year where the home was not used for business.

Day Care Facility

The business percentage of an area exclusively used for business in a day care facility is calculated under the business percentage method above. For the portion of the home regularly used, but not exclusively used for the day care business, multiply that portion by the business percentage of time.

EXAMPLE: *Jane uses her 1,600 square foot basement for day care. The total area of her home is 3,200 square feet. Her day care uses the basement an average of 12 hours per day, five days a week, 50 weeks per year. The basement is used by her family at night and on weekends. The business percentage of her home is calculated as follows: 1,600 ÷ 3,200 = 50%. 12 x 5 x 50 = 3,000 day care hours per year. 24 x 365 = 8,760 total hours per year. 3,000 ÷ 8,760 = 34.25% day care time percentage. Any direct expenses, such as repainting the basement, are multiplied by 34.25% to determine the deductible business portion of the expense. Any indirect expenses, such as utilities, are multiplied by 17.13% (50% x 34.25% = 17.13%) to determine the deductible business portion of the expense.*

DID YOU KNOW? In many cases, the basement and garage may be included in the total square footage of a day care provider's home when calculating the business use percentage. In addition to used rooms, area can include:

- Entryways, halls, food preparation areas, and bathrooms.
- Basement with laundry or tool rooms, storage or furnace area, etc.
- Garage where business car is parked or where household tools, trash cans, or stored day care items are kept.

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Business Use of Home

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Calculating Time Spent on Day Care

The provider should keep a log reflecting time spent conducting the day care business, including dates and hours each person was in the provider's care, and additional time spent organizing, preparing meals, and cleaning up.

Deduction Limitation

The business use of home deduction is limited to net income from the business.

Carryover of Unallowed Expenses

Deductions not allowed due to the net income limitation are carried over to the following year. They are added to current expenses from each category and subject to the deduction limit for that year for that category, whether or not the taxpayer lives in the same home during that year.

Simplified Option for Home Office Deduction

The simplified option for the home office deduction may be calculated as follows:

- A standard deduction is allowed of $5 per square foot of home used for business, limited to 300 square feet.
- Allowable home-related itemized deductions such as mortgage interest and real estate taxes are claimed in full on Schedule A, instead of apportioned between the business form and Schedule A.
- No home depreciation deduction is claimed and no later recapture of depreciation is required for the years the simplified method is used.

NOTE: Although recordkeeping is simplified, this option does not change the criteria for who may claim a home office deduction.

Cancellation Of Debt-Insolvency

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such as the value of a retirement account). Liabilities include the following items.

- The entire amount of recourse debts,
- The amount of nonrecourse debt that is not in excess of the FMV of the property that is security for the debt,

and

- The amount of nonrecourse debt in excess of the FMV of the property subject to the nonrecourse debt to the extent nonrecourse debt in excess of the FMV of the property subject to the debt is forgiven.

Example #1 – Amount of Insolvency More Than Cancelled Debt

Jill was released from her obligation to pay her personal credit card debt in the amount of $5,000. Jill received a Form 1099-C from her credit card lender showing cancelled debt of $5,000. Jill uses the insolvency worksheet to determine that her total liabilities immediately before the cancellation were $15,000 and the FMV of her total assets immediately before the cancellation were $7,000 which means that immediately before the cancellation, Jill was insolvent to the extent of $8,000 ($15,000 total liabilities minus $7,000 FMV of her total assets). Because the amount by which Jill was insolvent immediately before the cancellation was more than the amount of her debt cancelled, Jill can exclude the entire $5,000 cancelled debt from income.

Example #2 – Amount of Insolvency Less Than Cancelled Debt

Assume the same facts as Example #1, except that Jill's total liabilities immediately before the cancellation were $10,000 and the FMV of her total assets immediately before cancellation were $7,000. In this case, Jill is insolvent to the extent of $3,000 ($10,000 total liabilities minus $7,000 FMV of her total assets) immediately before the cancellation. Because the amount of the cancelled debt was more than the amount by which Jill was insolvent immediately before the cancellation, Jill can exclude only $3,000 of the $5,000 cancelled debt from income under the insolvency exception. Jill must include $2,000 of cancelled debt as an addition to her income, unless another exclusion applies.

Insolvency Worksheet

All amounts listed should be immediately before the debt cancellation.

LIABILITIES

1. Credit card debt .... $ ____________
2. Mortgages (and home equity loans)....... $ ____________
3. Car and other vehicle loans .... $ ____________
4. Medical bills owed............................. $ ____________
5. Student loans .... $ ____________
6. Accrued or past-due bills owed .... $ ____________
7. Federal or state income taxes due .... $ ____________
8. Judgments .... $ ____________
9. Business debts .... $ ____________
10. Other loans and past-due bills. .... $ ____________
11. **Total liabilities:** Add lines 1 through 10.. $ ____________

ASSETS

12. Cash and bank account balances .... $ ____________
13. FMV real estate................................. $ ____________
14. FMV vehicles. .... $ ____________
15. FMV household items .... $ ____________
    (computers, tools, jewelry, clothing, appliances, furniture, etc.)
16. Retirement accounts, IRAs, etc .... $ ____________
17. Cash value of life insurance................. $ ____________
18. Stocks and bonds.............................. $ ____________
19. Interest in education account .... $ ____________
20. Investments in collectibles .... $ ____________
21. Security deposits .... $ ____________
22. Interests in partnerships .... $ ____________
23. Value of investment in business .... $ ____________
24. Other assets .... $ ____________
25. **Total assets:** Add lines 12 through 24 ... $ ____________

26. AMOUNT OF INSOLVENCY:
Subtract line 25 from 11 .... $ ____________

If zero or less, taxpayer is not insolvent. If over zero, the amount is the extent to which the taxpayer is insolvent.

Dependent Support Worksheet

We regularly receive questions from clients about the ability to claim a family member or friend as a dependent on their tax return. The IRS has issued guidance of how to determine whether the person living in your household is eligible to be claimed as a dependent on your individual income tax return.

The support test is one of the factors used to determine eligibility for the dependency exemption for another person. This person may be your qualifying child or qualifying relative.

SUPPORT TEST	
Qualifying Child	The child cannot have provided more than half of his or her own support during the tax year.
Qualifying Relative	You must have provided more than half of the relative's support during the tax year.

What is considered support?

Total support includes amounts spent to provide food, lodging, clothing, education, medical and dental care, health insurance, recreation, transportation, and similar necessities.

- In general, the amount of an item of support is the expense incurred in providing that item.
- The amount of support for lodging is the fair rental value of the lodging, including a reasonable allowance for the use of furniture and appliances and for utilities provided.
- Expenses not directly allocable to any one member of the household, such as the cost of food for the household, must be divided among the household members.
- Property provided as support is measured by its fair market value.

When Should You Include Support Items?

A qualifying item is included in total support in the year it is paid. This is true even if you paid for the item with borrowed money that you repay in a later year.

Item Included in Total Support?	YES	NO
Life insurance premiums you paid on another person's life		X
Funeral expenses you paid		X
Amounts you paid for child care	X	
Dependent care or medical expenses paid out of your FSA or HSA	X	
Survivors' and Dependents' Educational Assistance payments used for the support of the recipient		X
Income and FICA taxes paid on the person's own earnings		X
GI Bill payments and allowances received by the person	X	
Part-time student's scholarship	X	
Full-time student's scholarship		X
Student loan proceeds used for current school or living expenses	X	
Student loan proceeds left in the bank for use in a future year		X
Value of car you own		X
Operating costs allocated to the other person's use of your car	X	
Computer used by entire household		X
Computer purchased as a gift for the other person	X	
Clothing purchased by the other person with his or her savings	X	
Wages earned by the other person but spent on someone else		X
Social Security payments received but not spent by the other person		X
Your 16-year-old son's trip to Mexico, financed by the liquidation of his college trust fund	X	
Inherited money left in a trust fund		X

Considered Provided By You?	YES	NO
Payments you receive from a placement agency, state, or county for support of a foster child	X	
Unreimbursed foster care expenses ineligible for charitable contribution deduction, and you are not in the foster care business	X	
Dependency allotments taken out of your military pay or contributed by the government	X	
Wages you pay to a child	X	
Social Security benefits payable to the child or relative	X	
Welfare benefits and food stamps you receive	X	
Your earnings, tax-exempt income, savings, or borrowed money that you spend on a child or relative	X	

If someone new has been added to your household, contact our office if you need help in determining whether they can be included on your tax return and the documentation that will be needed at tax time.