The Norton Tax Bulletin

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Virtual Currencies; 2019 and Later Return Changes; CA Healthcare Mandate

Dear Clients, family and friends,

Happy Holidays! I wanted to share with you some information as 2019 winds down to a close. I apologize for the length of the letter, but there is a lot to cover.

VIRTUAL CURRENCIES

The IRS has taken notice of the growing use of virtual currencies. A common type that is widely known is the Bitcoin. Cryptocurrencies are defined as a type of virtual currency that uses encryption to secure transactions digitally recorded on a distributed ledger. Virtual currencies also include digital currencies and any virtual currency having an equivalent value in, or acting as a substitute for, real currency, defined as the official legal currency of a country.

I have discussed these virtual currency transactions in the past and cautioned clients that these transactions are usually taxable, and if not properly reported, they could lead to an audit with penalties. Because there still appears to be misunderstanding concerning how virtual currencies are to be reported, the IRS released a Revenue Ruling in 2019 to provide additional information.

The IRS is concerned since by its review of filed returns, fewer than 1,000 taxpayers have actually reported their virtual currency transactions. To address this apparent non-compliance, it has been reported that the IRS is sending out letters to approximately 10,000 taxpayers who the agency believes had virtual currency transactions.

IRS Guidance

The IRS issued its Notice 2014-21 five years ago that essentially advised taxpayers that it considered virtual currencies to be property and not money. Further the Notice advised that it expected most transactions to be taxable. For example, a person who performs services for another and accepts as payment virtual currency is taxed on the fair market value (FMV) of that currency at time of receipt. The FMV amount reported as income becomes the “basis” for that block of currency and will determine whether a gain or loss is reported upon its subsequent sale or use in a transaction.

Virtual currency transactions have grown in frequency since the 2014 notice, and new forms of transactions have evolved. To address these new forms as well as to reaffirm its prior guidance, the IRS issued in October Revenue Ruling 2019-24. The ruling discusses two new types of transactions – a “hard fork” and an “air drop.” A “hard fork” is characterized as a change to a distributed ledger underlying a cryptocurrency that results in a split from the original distributed ledger. This transaction can lead to a new cryptocurrency being recorded on a new ledger. The other transaction – the “air drop” – is a means of distributing units of a cryptocurrency following a hard fork to the distributed ledger addresses of multiple taxpayers.

If through a hard fork (*with or without an air drop thereafter*) the taxpayer receives a new cryptocurrency, it will be taxable to the taxpayer if he or she has the ability to transfer, sell, exchange or otherwise dispose of the cryptocurrency units. The Revenue Ruling states that income realized from a hard fork will be treated as ordinary income (no capital gain treatment), and the basis for subsequent use of the currency will be the FMV at the time the new currency is received.

As an addendum to Revenue Ruling 2019-24, the IRS provided 43 frequently asked questions that provide taxpayers with examples of some of the transactions discussed in the revenue ruling and address the calculation of gain or loss, the determination of fair market value, and the calculation of basis.

Guidance is provided concerning virtual currency transactions that involve gifts or charitable contributions and “soft forks” - when a distributed ledger undergoes a protocol change that does not result in a diversion of the ledger and does not result in the creation of a new cryptocurrency. These types of transactions will generally not be taxable.

There is another issue addressed in the questions. That relates to the ability of the taxpayer to specifically identify the units of cryptocurrency involved in a particular transaction. If that is not possible, then the IRS will apply the first-in first-out means of identifying the basis for the currency transaction.

IRS letters

Beginning last July, around 10,000 taxpayers who the IRS believed were involved in virtual currency transactions and either failed to report them or reported them incorrectly began receiving letters from the Agency. The information was obtained by the IRS from at least one virtual currency exchange. These letters in three versions. These are:

(a) taxpayers who may not have met their U.S. filing and reporting requirements for transactions involving virtual currency,
(b) taxpayers who may not know the requirements for reporting transactions involving virtual currency, and
(c) taxpayers who may not have properly reported their transactions involving virtual currency.

The IRS has described these “soft letters” as an effort to get taxpayers to voluntarily come into compliance before enforcement actions are initiated. They also indicate that the service already possesses significant information to initiate those enforcement actions. The IRS conducted a similar campaign to get taxpayers with foreign assets or income to come into compliance voluntarily before facing enforcement.

Question on Form 1040 Schedule 1

Also, similarly to the approach that the IRS took with respect to foreign accounts, the IRS has added a question about virtual currencies to the tax return, in this case to the draft Schedule 1 of Form 1040. The question, requiring a yes or no response, is: *“At any time during 2019, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual*

currency?" This would appear to require all taxpayers to file a Schedule 1, if only to respond to this question.

Summary

Even with the additional guidance from the IRS, there remain a number of unanswered questions about the tax treatment of certain virtual currency transactions. As the types of virtual currencies continue to expand and the transactions in which they are involved become more varied, that is likely to continue to be the case.

The thrust of the IRS guidance so far is fairly consistent — virtual currency is property and any transaction that results in something being exchanged for something new is a taxable transaction unless a specific exception can be found in IRS guidance.

The IRS has already obtained considerable information from at least one virtual currency exchange and is likely to be able to obtain additional information. Certainly, any taxpayer who has received a soft letter from the IRS should work promptly to come into compliance before an enforcement action commences.

Those taxpayers who have not received a letter but have engaged in virtual currency transactions should also consider coming into compliance. As the IRS continues to develop additional information on taxpayers engaged in virtual currency transactions, it is not certain that taxpayers in the future will receive a soft letter before enforcements commence.

Tax Law Changes for 2019 and Later Returns

Congress actually did some work (*albeit at the end of the year*) and included a number of individual and business friendly tax provisions in its year-end spending package that was signed into law by President Trump on December 20, 2019. The **"Further Consolidated Appropriations Act, 2020"** (*2020 Act*) brought back to life many deductions and credits that had expired at the end of 2017, as well as a few others that had either expired at the end of 2018 or were scheduled to expire at the end of 2019. In addition, substantial changes were made to retirement-related tax provisions and new disaster-related tax provisions have been added. Some of the funding for these changes will come from increases made to various penalty provisions - notably increases in the penalties for failing to timely file a tax return or timely pay the tax due.

To the extent that you could have benefited from any of the resurrected 2017 tax provisions on your 2018 tax return, we should discuss filing an amended return to claim any refunds you may be due. The 2020 Act changes may also affect your 2019 tax liability.

The following is a recap of the provisions that have been extended that may require the filing of an amended tax return for 2018.

Deduction for Qualified Tuition and Related Expenses

The deduction for qualified tuition and related expenses is now available for 2018, 2019, and 2020 and applies to qualified education expenses paid during the year for yourself, your spouse, or a dependent. The maximum deduction is $4,000 of expenses if your modified adjusted gross income does not exceed $65,000 ($130,000 in the case of a joint return). If your income is more

than that, you can still deduct $2,000, as long as your adjusted gross income does not exceed $80,000 ($160,000 in the case of a joint return).

Expansion of Section 529 Plans

Several changes were made to the rules involving Section 529 plans - tax-advantaged savings plans designed to accumulate funds for future educational needs. First, tax-free distributions for higher education expenses now to apply to expenses for fees, books, supplies, and equipment required for the participation of a designated beneficiary in an apprenticeship program. The apprenticeship program must be registered and certified with the Secretary of Labor under Section 1 of the National Apprenticeship Act. Second, tax-free treatment applies to distributions of certain amounts used to make payments on principal or interest of a qualified education loan. No individual may receive more than $10,000 of such distributions, in aggregate, over the course of the individual's lifetime. Third, a special rule allows tax-free distributions to a sibling of a designated beneficiary (i.e., a brother, sister, stepbrother, or stepsister). This rule allows a 529 account holder to make a student loan distribution to a sibling of the designated beneficiary without changing the designated beneficiary of the account.

Treatment of Mortgage Insurance Premiums as Qualified Residence Interest

For 2018, 2019, and 2020, you can treat amounts paid during the year for qualified mortgage insurance as qualified residence interest. The insurance must be in connection with acquisition debt for a qualified residence.

Exclusion from Gross Income of Discharge of Qualified Principal Residence Indebtedness

For 2018, 2019, and 2020, gross income does not include the discharge of indebtedness of a taxpayer if the debt discharged is qualified principal residence indebtedness which is discharged before January 1, 2021.

Elimination of Certain Kiddie Tax Provisions

A special kiddie tax applies to a child who -

(1) (i) is under age 18 at the end of the year, (ii) is age 18 at the end of the year and did not have earned income that was more than half of the child's support, or (iii) was a full-time student over age 18 and under age 24 at the end of the year and did not have earned income that was more than half of the child's support;

(2) has more than a specified amount of unearned income;

(3) has a parent who is alive at the close of the tax year; and

(4) does not file a joint tax return.

There is also a reduced alternative minimum tax exemption for a child subject to the kiddie tax.

Prior to the Tax Cuts and Jobs Act of 2017 (TCJA), the kiddie tax that was imposed was the sum of (1) the tax that would be imposed if the child's taxable income were reduced by net unearned income, plus (2) the child's share of the allocable parental tax. The allocable parental

tax is: (1) the tax that would be imposed if the parents' taxable income included the net unearned income of all children to which the kiddie tax applies, minus (2) the tax that would be imposed without including such child's net unearned income.

The TCJA changed the way a child's unearned income was taxed so that, for years 2018-2025, the trust and estate tax rates, rather than a parent's tax rate, applied to such income. This is problematic because the income levels at which the higher trust and estate tax rates apply are lower than under the individual tax rates.

The new Tax Act eliminates the kiddie tax calculation that was enacted in the Tax Cuts and Jobs Act of 2017. Thus, estate and trust tax rates are no longer used to calculate a child's tax on unearned income. The Act also eliminates the reduced AMT exemption amount for a child to whom the kiddie tax applies.

The change in tax rates applicable to a child's unearned income applies to tax years beginning after December 31, 2019. The elimination of the special AMT exemption applies to tax years beginning after December 31, 2017.

Nonbusiness Energy Property Credit

The nonbusiness energy property credit is extended to property placed in service in 2018, 2019, and 2020. The nonbusiness energy property credit is available for (1) 10 percent of the amounts paid or incurred for qualified energy efficiency improvements installed during the tax year, and (2) the amount of residential energy property expenditures paid or incurred during the tax year. This credit had expired after 2017.

Equipment and materials can qualify for the Nonbusiness Energy Property Credit *only if they meet the standards set by the Department of Energy.* The manufacturer can tell you whether a particular item meets those standards.

For this credit, the IRS distinguishes between two kinds of upgrades.

The first is "qualified energy efficiency improvements," and it includes:

- Home insulation
- Exterior doors
- Exterior windows and skylights
- Certain roofing materials

The second category is "residential energy property costs." It includes:

- Electric heat pumps
- Electric heat pump water heaters
- Central air conditioning systems
- Natural gas, propane or oil water heaters
- Stoves that use biomass fuel
- Natural gas, propane or oil furnaces
- Natural gas, propane or oil hot water boilers
- Advanced circulating fans for natural gas, propane or oil furnaces

Alternative Fuel Refueling Property Credit

The credit for alternative fuel refueling property has been extended to property placed in service in 2018, 2019, and 2020. The credit is equal to 30 percent of the cost of any qualified alternative fuel vehicle refueling property placed in service by the taxpayer during the tax year.

Two-Wheeled Plug-In Electric Vehicle Credit

The credit available for the purchase of a qualified two-wheeled plug-in electric drive motor vehicle is extended to vehicles acquired in 2018, 2019, and 2020.

Another change made by the 2020 Act which may affect your 2019 tax return and future tax returns includes the following:

Reduction in Medical Expense Deduction Floor

The floor for deducting medical expenses for 2019 and 2020 has been reduced from 10 percent of adjusted gross income to 7.5 percent of adjusted gross income. In addition, there is no adjustment to the medical expense deduction when computing the alternative minimum tax for 2019 and 2020.

Some of the retirement-related provisions which may be of interest to you include the following:

Repeal of Maximum Age for Traditional IRA Contributions

The prohibition on contributions to a traditional IRA by an individual who has attained age 70½ has been repealed.

Increase in Age for Required Beginning Date for Mandatory Distributions

The required beginning date for required minimum distributions has been increased to 72 years old from 70 ½ years old. The former rules continue to apply to employees and IRA owners who attain age 70½ prior to January 1, 2020. The new provision is effective for distributions required to be made after December 31, 2019, with respect to individuals who attain age 70½ after December 31, 2019.

Penalty-Free Withdrawals from Retirement Plans for Individuals in Case of Birth of Child or Adoption

A new exception to the 10-percent early withdrawal tax applies in the case of a qualified birth or adoption distribution of up to $5,000 from an applicable eligible retirement plan. A qualified birth or adoption distribution is a distribution from an applicable eligible retirement plan to an individual if made during the one-year period beginning on the date on which a child of the individual is born or on which the legal adoption by the individual of an eligible adoptee is finalized. An eligible adoptee means any individual (other than a child of the taxpayer's spouse) who has not attained age 18 or is physically or mentally incapable of self-support.

Certain Taxable Non-Tuition Fellowship and Stipend Payments Treated As Compensation for IRA Purposes

For tax years after 2019, an amount includible in an individual's income and paid to the individual to aid the individual in the pursuit of graduate or postdoctoral study or research (such as a fellowship, stipend, or similar amount) is treated as compensation for purposes of IRA contributions.

Disaster-related provisions in the 2020 Act include the following:

Exception to Penalty for Using Retirement Funds

An exception to the 10-percent early withdrawal tax on a retirement-related distribution applies in the case of "qualified disaster distributions" from a qualified retirement plan, a Code Sec. 403(b) plan, or an individual retirement account (IRA). In addition, income attributable to a qualified disaster distribution may be included in income ratably over three years, and the amount of a qualified disaster distribution may be recontributed to an eligible retirement plan within three years. A "qualified disaster distribution" is any distribution from an eligible retirement plan made on or after the first day of the incident period of a qualified disaster and before June 18, 2020, to an individual whose principal place of abode at any time during the incident period is located in the qualified disaster area and who has sustained an economic loss by reason of such disaster, regardless of whether a distribution otherwise would be permissible.

Special Rules for Qualified Disaster-Related Personal Casualty Losses

Under a new provision, in the case of a qualified disaster-related personal casualty loss which arose as the result of a net disaster loss, such loss is deductible without regard to whether aggregate net losses exceed 10 percent of your adjusted gross income. In order to be deductible, however, such losses must exceed $500 per casualty. Such losses may be claimed in addition to the standard deduction and may be claimed even if you are subject to the alternative minimum tax.

Special Rule for Determining Earned Income

If you qualify, you may elect to calculate your earned income tax credit and additional child tax credit for an applicable tax year using your earned income from the prior tax year. Qualified individuals are permitted to make the election with respect to an applicable tax year only if their earned income for such tax year is less than their earned income for the preceding tax year. You are a qualified individual if (1) at any time during the incident period of a qualified disaster, you had your principal residence in the applicable qualified disaster zone, or (2) during any portion of such incident period, you were not in the applicable qualified disaster zone but your principal residence was in the applicable qualified disaster area and you were displaced from such principal place of abode by reason of the qualified disaster.

Automatic Extension of Filing Deadlines in the Case of Federally Declared Disasters

In the case of a federally declared disaster, qualified taxpayers get a mandatory 60-day extension period for filing and paying taxes.

Alimony – One delayed effect of the 2017 tax reform affects the treatment of alimony for some individuals starting in 2019. For divorces or separations entered into before 2019, alimony payments continue to be deductible for the payer and taxable for the recipient; such payments

also still qualify as earned income for purposes of the recipient's qualification for an IRA deduction.

For divorces or separations executed after December 31, 2018, alimony payments are *no longer deductible* for the payer. In addition, for the recipient, they are *no longer taxable income* and do not count as earned income for the purposes of IRA deduction. I expect that this change in taxability *(and deductibility*) will have an impact on divorce settlement negotiations.

Divorces or separations entered into *before* 2019 continue to follow the pre-2019 rules *unless they have been modified after December 31, 2018*; in that case, the alimony payments are subject to the post-2018 rules *if the modification expressly provides for this*.

Finalization of State and Local-Tax Deduction Limitation – The 2017 tax reform limited the itemized deduction for state and local taxes (*abbreviated as SALT*) to $10,000 *(or $5,000 for married individuals filing separately).* This has adversely impacted taxpayers in high-tax states such as California, Connecticut, New Jersey, and New York. Elected officials in several states have attempted to work around this restriction by establishing (*or proposing to establish*) state charities. The idea is that taxpayers would make deductible contributions that, in return, would give them tax credits against their SALT equal to most of the value of the charitable contributions. Unfortunately, these officials have overlooked the 1986 U.S. Supreme Court ruling that, if a taxpayer receives something in return for a contribution (*i.e., a quid pro quo*), the contribution is not deductible.

The final IRS regulations generally reduce the charitable-contribution deduction by the amount of any SALT credit received. However, *as an exception*, if the credit does not exceed 15% of the contribution, the entire contribution is deductible.

The limitation on the SALT deduction coupled with the increased standard deduction has resulted in far more taxpayers opting to take the much higher standard deduction in lieu of itemizing (*filing Schedule A*) on their returns.

Penalty for Not Being Insured – The Tax Cuts and Jobs Act (tax-reform) that was enacted at the end of 2017 eliminated the Obamacare shared-responsibility payment, effective starting in 2019. Congress didn't actually repeal this penalty; instead, it effectively repealed it by tweaking - setting zero values for both the percentage of household income used in the calculation and the flat dollar amount of the penalty. As a result, the amount of the penalty is always zero. However, keep in mind that the penalty could be restored in the future if the direction that the political winds are blowing changes.

Beginning in 2020, some states (*like California*) may pick up where the federal government left off and charge a penalty to residents without qualified health insurance coverage. I will address California's changes later.

Qualified Opportunity Funds – Taxpayers who receive capital gains on the sale or exchange of property *(if the other party is unrelated)* may elect to defer – and, potentially, partially exclude – those gains from their gross income if they are reinvested in a qualified opportunity fund (QOF) within 180 days of the sale or exchange. The amount of the gain (*not the amount of the proceeds, as in Sec. 1031 deferrals)* needs to be reinvested in order to defer the gain. The deferral period ends when the QOF investment ends or on December 31, 2026 – whichever is sooner. At that time, taxes must be paid on the deferred gain.

However, 10% of the deferred gains are forgiven if QOF investments have been held for at least 5 years, and 15% of the gains are forgiven when those investments have been held for at least 7 years. Note that, with the deferral end date of December 31, 2026, qualifying for the 15% forgiveness requires a QOF investment on or before December 31, 2019.

Seniors Get a Special Tax Form – Lawmakers have long sought to provide taxpayers who are age 65 and older with a simplified tax form in place of the Form 1040. In the 2018 budget bill, Congress finally included a requirement that the IRS create such a form. As a result, the IRS will introduce Form 1040-SR, which will look a lot like the old form looked before the 2018 tax reform instituted its (*politically motivated*) division of the Form 1040 into multiple postcard-size schedules. It is unclear how much simpler the Form 1040-SR will be, but it will be available for 2019 returns. The use of the special Form 1040-SR will be optional.

Family and Medical Leave Credit –The paid family and medical leave credit under Code Sec. 45S is extended through 2020. The credit allows eligible employers to claim a general business credit equal to an applicable percent of the amount of wages paid to qualifying employees during any period in which such employees are on family and medical leave, provided that the rate of payment under the program is at least 50 percent of the wages normally paid to an employee. Prior to being extended, this provision had been set to expire on 12/31/2019.

This program provides employers with a tax credit equal to 12.5% of the wages they paid to qualifying employees during any period when those employees were on family and medical leave, provided that the rate of the leave payments are at least 50% of the employees' normal wages. The credit can be claimed for a maximum of 12 weeks of leave for any employee during the tax year. For each percentage point for which the leave payments exceed 50% of normal wages, this credit increases by 0.25 percentage points (*up to a maximum of 25%).* Participation in this credit program is optional.

Inflation Adjustments – Just about every tax-related value is adjusted for inflation. Some values are adjusted for any level of change, but others are adjusted only if the change reaches at least a specific dollar amount (so these values may not change every year). The table below includes the actual 2019 inflation adjustments and the projected 2020 adjustments for some of the most frequently encountered values.

Year	**2018**	**2019**	**2020**
Standard Deduction			
Single or Married Filing Separately	12,000	12,200	12,400
Head of Household	18,000	18,350	18,650
Married Filing Jointly	24,000	24,400	24,800
Additional Standard Deduction (Age 65+ or Blind)			
Unmarried	1,600	1,650	1,650
Married	1,300	1,300	1,300
Other Values			
Annual Gift-Tax Exclusion	15,000	15,000	15,000
Foreign Earned-Income Exclusion	103,900	105,900	107,600
IRA Contribution Limit	5,500	6,000	6,000
IRA Contribution Limit (Age 50+)	6,500	7,000	7,000
401(k) Contribution Limit	18,500	19,000	*
401(k) Contribution Limit (Age 50+)	24,500	25,000	*

All values are in U.S. dollars.
* Value not available as of publication

Form W-4 Revision – During the previous tax season, many people received a smaller federal tax refund than normal or actually owed taxes despite usually getting a refund. In most cases, this was due to the last-minute passage of the tax-reform law at the end of 2017, which did not give the IRS sufficient time to adjust the W-4 form and related computation tables for the 2018 tax year so as to account for all of the new law's changes. The planned major revision to the W-4 for the 2019 tax year has since been delayed until 2020, so all taxpayers should make sure that their 2019 withholding is adequate.

If you are conversant with tax terminology, you can use the IRS's newly updated *withholding estimator*. This tool helps taxpayers to determine whether their employers are withholding the right amount of tax from their paychecks. However, please note that the results are only as good as the information that is put into the estimator. Users need to properly estimate their other income for the year from various sources.

CALIFORNIA'S HEALTHCARE MANDATE

Updated November 21, 2019

The State of California is working to reduce the number of uninsured families with the adoption of a new state individual health care mandate.

Here are three things California residents need to know:

1. Make sure you have health coverage

The mandate, which takes effect on January 1, 2020, requires Californians to have qualifying health insurance coverage throughout the year. Many people already have qualifying health insurance coverage, including employer-sponsored plans, coverage purchased through Covered California or directly from insurers, Medicare, and most Medicaid plans.

Under the new mandate, those who fail to maintain qualifying health insurance coverage could face a financial penalty unless they qualify for an exemption. Generally speaking, a taxpayer who fails to secure coverage will be subject to a penalty of $695 when they file their 2020 state income tax return in 2021. The penalty for a dependent child is half of what it would be for an adult.

The penalty is based on your state income and the number of people in your household.

Summary of possible penalties

Household Size	If You Make Less Than	You May Pay
Individual	$45, 500	$695
Married Couple	$91,000	$1,390
Family of 4	$140,200	$2,085

To avoid a penalty, California residents need to have qualifying health insurance for themselves, their spouse or domestic partner, and their dependents for each month beginning on January 1, 2020. The open enrollment period to sign up for health care coverage through Covered California is scheduled for October 15, 2019 through January 31, 2020.

2. Exemptions available

There are exemptions to the penalty, and families will not have to pay a penalty if the cost of their health care coverage exceeds a certain percentage of their income. Most exemptions from the mandate will be claimed when filing 2020 state income tax returns in early 2021. Additional exemptions from the mandate will be granted through Covered California beginning in January 2020.

Exemptions

Exemptions Claimed on State Tax Return

- Income is below the tax filing threshold
- Health coverage is considered unaffordable (exceeded 8.24% of household income for the 2020 taxable year)
- Families' self-only coverage combined cost is unaffordable
- Short coverage gap of 3 consecutive months or less
- Certain non-citizens who are not lawfully present
- Certain citizens living abroad/residents of another state or U.S. territory
- Members of health care sharing ministry
- Members of federally-recognized Indian tribes including Alaskan Natives
- Incarceration (other than incarceration pending the disposition of charges)
- Enrolled in limited or restricted-scope Medi-Cal or other coverage from the California Department of Health Care Services

3. Financial assistance available

To help Californians meet the requirement to have insurance coverage, the state will provide financial assistance to qualifying individuals and families, dependent on their household size and income, through Covered California. This new state financial assistance will be in addition to federal financial assistance some already receive through Covered California. Options for no-and low-cost coverage are also available through the Medi-Cal program.

To find out more about health insurance options and financial assistance, visit CoveredCA.com.

I hope that you find the information in this newsletter of value to you.

Happy New Year

Very truly yours,

Dick Norton

This newsletter is not intended or written by me to constitute written advice that you may rely upon to avoid penalties that may be imposed by any taxing authority. An attorney should always be consulted in matters involving legal issues such as those inherent in estate planning or other matters where an attorney is best qualified and authorized to provide such guidance.